92-270 (4)

No. ___

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

Pacific First Bank,

Petitioner,

v.

Commissioner of Internal Revenue,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

APPENDIX

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FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

PACIFIC FIRST FEDERAL SAVINGS BANK, *Petitioner-Appellee,*	No. 91-70116 Tax Ct. No. 27606-87
V.	ORDER
COMMISSIONER INTERNAL REVENUE SERVICE, AND *Respondent-Appellant.*	AMENDING OPINION DENYING REHEARING

Appeal from a Decision of the

United States Tax Court

Argued and Submitted

October 9, 1991-Seattle, Washington

Filed February 7, 1992

Amended May 21, 1992

Before: J. Clifford Wallace, Chief Judge, Procter Hug, Jr.

and Pamela Ann Rymer, Circuit Judges.

Opinion by Chief Judge Wallace; Dissent by Judge Hug

SUMMARY

Income Taxes

Reversing and remanding a decision of the Tax Court, the court of appeals held that although the Tax Court erred in invalidating Treasury Regulation §1.593,6A(b)(5)(vi) and (vii), concerning the recalculation of mutual institutions' reserve deductions because of the carry-back of net operating losses, the Tax Court had to also determine whether the retroactive application of the regulation was invalid.

The Commissioner of Internal Revenue challenged the Tax Court's invalidation of Treasury Regulation §1.593-6A(b)(5)(vi) and (vii). Under that regulation, the Commissioner of Revenue determined that Pacific First Federal Savings Bank's net operating loss deduction reduced its taxable income for the carry-back years in question, thus Pacific was required to recalculate its reserve deductions. A previous regulation did not require that the reserve deduction be recalculated. The Tax Court determined that the regulation was invalid.

[1] The court believed much of the Sixth Circuit's reasoning in upholding the regulation was persuasive but wrote separately

only to clarify the analysis supporting the validity of the regulation. [2] The court therefore concluded that where the tax court decision has been thoroughly considered and rejected by another circuit, no special deference should be given to the tax court's conclusions of law. [3] The court did not need to decide whether *Chevron* applied to the regulations in this case, because the traditional rule of deference to Treasury regulations supported the decision to uphold the challenged regulation. [4] The Treasury's explanation for the regulatory change in this case was also sufficient to warrant deference.

[5] The regulation in question was a reasonable construction of the statute. Since section 172 net operating losses are deductions allowed by the Internal Revenue Code, Pacific's reserve deduction appeared to be limited by the amount of taxable income remaining after section 172 losses have been deducted. [6] The challenged regulation was also a reasonable interpretation of the legislative history. The prior regulations did not require the reserve deduction to be recalculated when a section 172 loss was deducted from taxable income. [7] Although Congress did not explicitly state an intention to ameliorate all of the consequences of taxing individuals on an annual basis, the Treasury's regulatory shift avoids inequitable windfalls based on the timing of income and losses. [8] The regulation merely required that the taxpayer who selected the percent of taxable income method to calculate the reserve deduction take into account the new taxable income figure in the carry-back year. The regulation was thus upheld as a rea-

sonable exercise of the responsibility delegated by Congress to the Treasury. [9] However, the case was remanded to the Tax Court for a determination of whether the retroactive application of the regulation is valid.

Dissenting, Judge Hug would have affirmed the judgment of the Tax Court.

COUNSEL

Bruce R. Ellisen, Tax Division, United States Department of Justice, Washington, D.C., for the respondent-appellant.

John F. Coverdale, Fried, Frank, Harris, Shriver & Jacobson, Washington, D.C., for the petitioner-appellee.

ORDER

The opinion filed in the above case on February 7, 1992, is amended as follows:

Slip op. 1287, line 9: delete ", which we follow here";

Slip op. 1294, last paragraph, lines 6-12: delete sentence beginning "For example, . . ." and substitute the following: "For example, the argument that the Treasury's regulatory shift violates congressional intent because it decreases the incentives to accumulate reserves and threatens depositor safety is premised upon the belief that Congress carefully considered all of the effects of allowing taxpayers to disregard section 172 losses when

calculating their reserve deduction."

A majority of the panel has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied, and the suggestion for rehearing en banc is rejected.

OPINION

WALLACE, Chief Judge:

The Commissioner of Internal Revenue (Commissioner) appeals the tax court's decision that Treasury Regulation § 1.593-6A(b)(5)(vi), (vii) is invalid because it does not implement the congressional mandate in a reasonable manner. The tax court had jurisdiction pursuant to I.R.C. §§ 6214, 7442. (All references are to the Internal Revenue Code of 1954 (Code or I.R.C.), unless otherwise indicated.) We have jurisdiction over this timely appeal

pursuant to I.R.C. § 7482. We reverse and remand to the tax court for further proceedings.

I

During the relevant period, Pacific First Federal Savings Bank (Pacific) was a mutual savings and loan association with its principal place of business in Tacoma, Washington. Pacific claimed deductions for reasonable additions to a reserve for bad debts for the taxable years 1971 through 1980. The Code provides special rules for determining reasonable additions to reserves for domestic building and loan associations, mutual savings banks, and certain cooperative banks (collectively referred to as "mutual institutions"). *Id.* § 593(a). In general, mutual institutions may deduct "the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans," but that amount may not exceed a cap determined under one of three alternative methods: (1) the percentage of taxable income method, under which the deduction is equal to a specified percentage of the institution's taxable income; (2) the percentage of loans method, under which the deduction is based on a specified percentage of the relevant loans; and (3) the experience method, under which the deduction is based on the taxpayer's bad debt history. *Id.* §§ 593(b), 585(b). The mutual institution may choose the method that provides the highest deduction. *Id.* § 593(b)(1)(B).

During the relevant years, Pacific used the percentage of taxable income method to compute its reserve deduction. Pursuant to section 593, the percentage rate used to determine the deduction for 1971 was 54 percent. The rate was gradually reduced each year until it reached 40 percent for 1979 and each year thereafter. *Id.* § 593(b)(2)(A).

During the taxable years 1981 and 1982, Pacific sustained net operating losses in the amounts of $43,459,246 and $27,748,382, respectively. At that time, the Code permitted mutual institutions to carry back net operating losses to each of the ten taxable years preceding the year of the loss. *Id.* § 172(b)(1)(F). The net operating loss is first carried back to the earliest permissible year, with any unabsorbed amount carried forward chronologically until fully absorbed. *See id.* § 172(b)(2). When carried back, the net operating loss is treated as a deduction, thereby reducing taxable income for that year. The taxpayer then receives an appropriate refund. Pacific carried its 1981 net operating loss back to the years 1971 through 1978 and carried its 1982 net operating loss back to the years 1978 and 1979. Pacific did not make any adjustment to its bad debt reserve deductions for the years 1971 through 1979, even though taxable income for those years was reduced by the loss carry-backs.

During an audit, the Commissioner determined that because the net operating loss deduction reduced taxable income for the

carry-back years, Pacific was required to recalculate its reserve deductions. Although earlier regulations issued by the Secretary of the Treasury (Treasury) indicated that the reserve deduction did not need to be recalculated, the regulation in effect when Pacific's net operating losses occurred provides that deductions for section 172 losses reduce taxable income for purposes of determining the allowed reserve deduction. *Compare* Treas. Reg. § 1.593-6(b)(2)(iv) (1971) (taxable income for purposes of section 593 is not reduced by section 172 losses) *with* Treas. Reg. § 1.593-6A(b)(5)(vi), (vii) (1982) (for the relevant years, taxable income for purposes of section 593 is reduced by section 172 losses). The Commissioner contended that pursuant to the applicable regulations, Pacific was required to recompute its reserve deductions for the loss carry-back years. According to the Commissioner, Pacific's income taxes for 1978, 1979, and 1980 were deficient in the amounts of $1,743,066, $5,057,885, and $2,512,321, respectively.

Pacific petitioned the tax court seeking redetermination of the deficiencies. Pacific argued that Treasury Regulation § 1.593-6A(b)(5)(vi), (vii) is an unreasonable interpretation of the statute and, therefore, invalid. The tax court, in a 13-5 reviewed decision, held that the regulation was invalid. *See Pacific First Federal Savings Bank v. Commissioner*, 94 T.C. 101, 107 (1990) *(Pacific First)*.

ii

[1] The Commissioner argues that the tax court erred in invalidating Treasury Regulation § 1.593-6A(b)(5)(vi), (vii). The only other circuit court to address this issue has criticized and rejected the tax court's decision in *Pacific First*. *See Peoples Federal Savings & Loan Association of Sidney v. Commissioner*, No. 90-1939, slip op. at 2, 28-31 (6th Cir. Nov. 6, 1991) *(Peoples Federal); see also First Federal Savings Bank of Washington v. United States*, 766 F. Supp. 897, 899-900 (E.D. Wash. 1991), *appeal docketed*, No. 91-35690 (9th Cir. May 21, 1991) (rejecting the tax court's decision in *Pacific First* and upholding the regulation). "Uniformity among the circuits is especially important in tax cases to ensure equal and certain administration of the tax system. We would therefore hesitate to reject the view of another circuit." *First Charter Financial Corp. v. United States*, 669 F.2d 1342, 1345 (9th Cir. 1982) *(First Charter)*. We believe much of the Sixth Circuit's reasoning is persuasive, and write separately only to clarify the analysis supporting the validity of the regulation.

iii

In the past, there has been some ambiguity in our circuit over the proper scope of review of tax court decisions. *Estate of*

Schnack v. Commissioner, 848 F.2d 933, 935 (9th Cir. *1988) (Estate of Schnack)*. The parties have stipulated to the facts in this case. Therefore, we are only faced with a question of law concerning the validity of the regulation, which we review de novo. Id. Some of our earlier decisions, however, appear to indicate that deference should be given to decisions of the tax court. *See, e.g., First Charter*, 669 F.2d at 1345. In *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1411-13 (9th Cir. 1986), we recognized the difficulty with some of our previous decisions and concluded that, in general, no special deference should be given the tax court when reviewing a pure question of law. *See also Lynch v. Commissioner*, 801 F.2d 1176, 1178-79 (9th Cir. 1986) (no deference to tax court's conclusions of law). This interpretation of our circuit's case law history was followed in *Estate of Schnack*, 848 F.2d at 935.

[2] Even if deference to the tax court on a legal question is proper in certain circumstances, such deference would be inappropriate in this appeal. The purpose of deferring to legal decisions of the tax court is to foster the value of tax law uniformity. As we pointed out in *Vukasovich*, in the realm of national tax law, "it is more important that the applicable rule of law be settled than it be settled right." 790 F.2d at 1413, *quoting Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting). Therefore, we conclude that in cases such as this one, where the tax court decision has been thoroughly considered

and rejected by another circuit, no special deference should be given to the tax court's conclusions of law.

[3] The parties also disagree over the degree of deference to be given to the Treasury's regulation. The challenged regulation was issued under the Treasury's authority to "prescribe all needful rules and regulations.... I.R.C. § 7805. The Sixth Circuit concluded that the rule of deference established by *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984) *(Chevron)*, should be applied to this interpretive regulation. *See Peoples Federal*, No. 90-1939, slip op. at 18-19. We need not decide whether *Chevron* applies to the regulations in this case, however, because the traditional rule of deference to Treasury regulations supports our decision to uphold the challenged regulation. The Supreme Court has consistently held that courts must defer to the Treasury's interpretive regulations if they "implement the congressional mandate in some reasonable manner." *National Muffler Dealers Association* v. *United States*, 440 U.S. 472, 476 (1979) *(National Muffler)* (internal quotations omitted); *see also Cottage Savings Association v. Commissioner*, 111 S. Ct. 1503, 1508 (1991) (Treasury's interpretations of the Code should be upheld "so long as they are reasonable").

In determining whether the regulation is consistent with the congressional mandate, "we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose." *National Muffler*, 440 U.S. at 477. The majority of

the tax court apparently determined that this "harmony" standard requires the reviewing court to engage in a plenary review of the statute and legislative history to determine the appropriate meaning of the Code. *Pacific First*, 94 T.C. at 115. However, National Muffler only requires that the court determine whether the challenged regulation is a reasonable interpretation of the statute's plain language, its origin, and its purpose." *First Charter*, 669 F.2d at 1348.

Pacific contends that an interpretation that is neither long-standing nor consistent with previous interpretations is not entitled to deference. The cases cited by Pacific, however, do not address the deference to be given to a Treasury regulation. *See, e.g., Lynch v. Dawson*, 820 F.2d 1014, 1020 (9th Cir. 1987); *United Transportation Union v. Lewis*, 711 F.2d 233, 242 (D.C. Cir. 1983). While recognizing that the consistency and contemporaneity of the Treasury's interpretation are relevant, the Supreme Court in *National Muffler* deferred to a regulation that reversed the Treasury's previous interpretation that was in force for ten years. *National Muffler*, 440 U.S. at 484-86. National Muffler is consistent with recent Supreme Court decisions that have also "rejected the argument that an agency's interpretation 'is not entitled to deference because it represents a sharp break with prior interpretations' of the statute in question." Rust v. Sullivan, 111 S. Ct. 1759, 1769 (1991), quoting *Chevron*, 467 U.S. at 862. Thus, we follow *National Muffler* and reject "the rigid view that

an agency may not alter its interpretation in light of administrative experience." *National Muffler*, 440 U.S. at 485.

Pacific also contends that we should not defer to the regulation because the Treasury did not supply an adequate justification for the regulatory shift. However, a 1978 memorandum written by the Acting Assistant Secretary for Tax Policy to the Secretary of the Treasury clearly indicates that the Treasury was convinced that "the position with respect to taxable income taken in the prior regulation was mistaken and without statutory authority." The memorandum states that the previous regulation "permitted thrift institutions to take unwarranted bad debt deductions through a liberal definition of the term 'taxable income', which is contrary to the definition provided in the Code." This is the same reason the Commissioner has advanced in this case for upholding challenged regulation.

[4] Pacific argues that a different rationale for the new regulation was provided by the Treasury in public notices proposing the regulation and adopting the final regulations. These notices stated that the regulations were being amended to conform to amendments to the Code made by the Tax Reform Act of 1969, Pub. L. No. 91-172, § 432, 83 Stat. 487, 620-23. *See* 36 Fed. Reg. 15050 (1971); T.D. 7549, 1978-1 C.B. 185, 185-86. These notices, however, addressed numerous changes in the regulations, and the justification for the changes was not linked to any single

amendment. The justification for each amendment to the regulations would have been clearer had the Treasury published specific reasons for each regulatory change. Nonetheless, the Supreme Court has deferred to a regulation when "[n]othing in the regulations or case law directly explain[ed] the regulatory shift," *see National Muffler*, 440 U.S. at 485 (citation omitted), concluding that it was sufficient that an otherwise apparent change in regulations "incorporated an interpretation thought necessary to match the statute's construction to the original congressional intent." *Id.* Therefore, the Treasury's explanation for the regulatory change in this case is also sufficient to warrant deference.

Although we reject Pacific's argument that the regulation should be given no deference, we recognize that the challenged regulation is less persuasive than would be a contemporaneous, long-standing Treasury regulation that had remained in force after Congress considered and reenacted the pertinent Code provisions. However, we cannot usurp the Treasury's authority and invalidate the regulation unless it is an unreasonable construction of the statute and its legislative history. *See id.* at 488-89.

[5] The Treasury's regulation is a reasonable construction of the text of sections 593 and 172. Section 593(b)(2) limits the reserve deduction taken by Pacific to a specified percentage of taxable income. Although taxable income is not defined in section 593, it is defined in section 63(a) as "gross income minus the deductions allowed by this chapter." I.R.C. § 63(a). Since section 172 net operating losses are deductions allowed by this chapter, Pacific's reserve deduction appears to be limited by the amount of taxable income remaining after section 172 losses have been deducted.

The Commissioner points out that although section 593 does not expressly state whether deductions for section 172 losses should be excluded from taxable income, the section does exclude certain items normally included within the concept of taxable income. *Id.* § 593(b)(2)(E). In addition, several other Code sections that require computations based on taxable income contain an explicit provision stating that taxable income is calculated without regard to section 172 loss deductions. *See id.* §§ 170(b)(2)(C); 246(b)(1). Applying the principle of *expressio unius est exclusio alterius,* the Commissioner argues that if Congress intended the reserve deduction not to be affected by section 172 losses, Congress would have so provided in the text of the amendment.

Pacific, however, argues that the text can also be construed as supporting the argument that the reserve deduction should not be recalculated when a net operating loss is carried back. Section 172 provides that "[t]he portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the *taxable income* for each of the prior taxable years to which such loss may be carried." *Id.* § 172(b)(2) (emphasis added). Taxable income is defined as "gross income minus the deductions allowed by this chapter." *Id.* § 63(a). Since the deduction for reasonable reserves is a deduction allowable under this chapter, the amount of the net operating loss that may be absorbed in a given year is arguably calculated after the reserve deduction is subtracted from taxable income. Therefore, since both the reserve deduction and the net operating loss deduction are affected by the amount of taxable income, it is necessary to determine which deduction will reduce taxable income first.

The interpretations offered by the Treasury and Pacific both appear reasonable. However, "the choice among reasonable interpretations is for the Commissioner, not the courts." *National Muffler,* 440 U.S. at 488. Therefore, we defer to the Treasury's interpretation of the statute.

B.

[6] The challenged regulation is also a reasonable interpretation of the legislative history. Neither party has provided any evidence that Congress specifically addressed the question whether the reserve deduction should be recalculated after a section 172 loss is deducted from taxable income. Treasury was forced to balance two competing legislative policies underlying section 593. One purpose for allowing bad debt reserve deductions is to encourage mutual institutions to accumulate bad debt reserves. *See Arcadia Savings & Loan Association v. Commissioner,* 300 F.2d 247, 251 (9th Cir. 1962) *(Arcadia).* Congressional tax reform, however, has reduced the benefit that section 593 confers upon mutual institutions in order to further a policy of taxing mutual institutions and other corporate taxpayers at a similar rate. *See, e.g.,* Tax Reform Act of 1969, Pub. L. No. 91-172, § 432(a), 83 Stat. 487, 620 (codified at I.R.C. § 593) (reducing the allowable deduction from 60 to 40 percent over a ten-year period); H.R. Rep. No. 413, 91st Cong., 1st Sess., pt. 1, at 125, *reprinted in* 1969-3 C.B. 200, 278 (previous reserve deduction allowed "these institutions to pay a much lower average effective rate of tax than the average effective rate for all corporations"). The Treasury amended its regulations to treat mutual institutions more like other taxpayers and to reflect what it perceived was the proper balance between these two competing congressional objectives.

The Treasury was also required to consider the purposes underlying section 172 when amending the regulation. One purpose of section 172 is to improve the equity of the tax system between taxpayers with fluctuating and relatively stable incomes. *See Aetna Casualty & Surety Co. v. United States*, 568 F.2d 811, 819 (2d Cir. 1976). Although the purpose of section 172 is clear, the application of the prior regulatory scheme, which was adopted by the tax court majority, results in a windfall to taxpayers with fluctuating income and losses. The prior regulations did not require the reserve deduction to be recalculated when a section 172 loss was deducted from taxable income. *See* Treas. Reg. § 1.593-6(b)(2)(iv) (1971). For example, an institution with $2,000,000 income evenly divided over two years would be taxed as follows:

	1979	*1980*
Income before percentage method deduction	1,000,000	1,000,000
Percentage method reserve deduction at 40%	(400,000)	(400,000)
Taxable Income	600,000	600,000
Tax at 46%	276,000	276,000

However, an institution with an uneven distribution of income would pay significantly less taxes:

	1979	*1980*
Income before percentage method deduction	3,000,000	(1,000,000)
Percentage method reserve deduction at 40%	(1,200,000)	-0-
Net operating loss carry-back	(1,000,000)	-0-
Taxable Income	800,000	-0-
Tax at 46%	368,000	-0-

Both hypothetical taxpayers experienced a gain of $2,000,000 over two years, but the prior regulatory scheme allows the second taxpayer to pay a tax of only $368,000 while the first taxpayer pays $552,000. The second taxpayer receives a windfall of $184,000 because its income was distributed unevenly between the two years.

[7] Under the challenged regulation, the first taxpayer pays the same tax as before. The second institution, however, now pays the same tax as the first taxpayer:

	1979	*1980*
Income before percentage method deduction	3,000,000	(1,000,000)
Net operating loss carry-back	(1,000,000)	-0-
Taxable income before reserve deduction	2,000,000	-0-
Percentage method reserve deduction at 40%	(800,000)	-0-
Taxable Income	1,200,000	-0-
Tax at 46%	552,000	-0-

Although Congress did not explicitly state an intention to ameliorate all of the consequences of taxing individuals on an annual basis, the Treasury's regulatory shift avoids inequitable windfalls based on the timing of income and losses. The regulation, therefore, can hardly be deemed unreasonable.

Pacific argues that the Treasury's regulation violates the general purpose of sections 593 and 172 in several ways. First, Pacific contends that the amended regulation undermines depositor safety by essentially repealing the reserve deduction for some taxpayers. Second, Pacific contends that in 1969 the House and Senate specifically considered the effect of the prior regulations on the tax rate in reaching a compromise on how much to curtail the reserve deduction benefit. *See* H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. 311, *reprinted in* 1969-3 C.B. 644, 664. Pacific

asserts that the Treasury's regulatory shift upsets this compromise. Third, Pacific argues that the Treasury's reinterpretation effectively nullifies the ten year carry-back provision by reducing the benefit of carrying back losses.

Although Pacific does not argue that the traditional reenactment doctrine applies in this case, each of Pacific's arguments depends on the assumption that in amending the Code, Congress considered the effect of the prior regulatory scheme, or the desirability of recalculating the reserve deduction when section 172 losses are carried back. For example, the argument that the Treasury's regulatory shift violates congressional intent because it decreases the incentives to accumulate reserves and threatens depositor safety is premised upon the belief that Congress carefully considered all of the effects of allowing taxpayers to disregard section 172 losses when calculating their reserve deduction. Pacific has presented no persuasive evidence that Congress gave any scrutiny to the prior regulations or otherwise considered whether requiring taxpayers to recalculate reserve deductions when section 172 losses are carried back would threaten depositor safety. The prior regulations were complex and, as discussed above, resulted in differing levels of taxation depending upon the timing of income and losses. Absent clearer evidence that Congress considered the effect of the prior regulations, or the need to disregard section 172 losses when calculating the reserve deduction, we cannot usurp the Treasury's congressionally

delegated authority to interpret this complex scheme.

[8] In addition, Pacific has mischaracterized the effect of the regulation. The regulation does not repeal the percentage of taxable income method or the generous carry-back period allowed for mutual institutions. The regulation merely requires that the taxpayer who selected the percent of taxable income method to calculate the reserve deduction take into account the new taxable income figure in the carry-back year. We hold that the regulation is a reasonable exercise of the responsibility delegated by Congress to the Treasury. *National Muffler*, 440 U.S. at 477.

C.

Pacific also contends that the regulation is inconsistent with our decisions holding that "[e]stimates fairly made at the time may not be enlarged in the light of subsequent events . . . ." *See, e.g., Rogan v. Commercial Discount Co.*, 149 F.2d 585, 590 (9th Cir.) (internal quotations omitted), cert. denied, 326 U.S. 764 (1945). The Treasury, however, is not requiring mutual institutions to revise an estimate. Section 593 provides a deduction for "the amount determined by the taxpayer to be a reasonable addition to the reserve . . . ." I.R.C. § 593(b)(1)(B). The percentage of taxable income method is merely a means of calculating the cap on what the taxpayer may estimate as a reasonable deduction. The

Treasury's regulation only requires a permissible adjustment "of the formula determining the limits of the reserve allowable." *See Rio Grande Building & Loan Association v. Commissioner*, 36 T.C. 657, 668 (1961) (dicta).

Pacific contends that section 593(b)(2) is more than a method of calculating the limit on the deduction. Pacific relies on *Arcadia* for the proposition that the percentage of taxable income method "furnishes a formula for measuring a reasonable addition to a reserve for bad debts.... *Arcadia*, 300 F.2d at 251. In *Arcadia*, however, we were not asked to decide whether the percentage of taxable income method is (1) a formula for calculating what is a reasonable addition to reserves, or (2) a formula for determining the limit on what a taxpayer may deem to be a reasonable addition. Thus, *Arcadia* is not dispositive here.

Moreover, Pacific's reliance on *United States v. Foster Lumber Co.*, 429 U.S. 32 (1976), is also misplaced. *Foster Lumber* only addresses whether capital gains income must be included in the taxable income offset by net operating loss deductions. *Id.* at 33-36. The Court did not decide the scope of the term "taxable income" in light of the purposes behind sections 172 and 593.

[9] Pacific contends that even if the regulation is upheld as a reasonable construction of the statute, the retroactive application of the regulation is invalid. Pacific raised this issue below, but the tax court did not reach the retroactivity question because it invalidated the regulation. We remand this case to allow the tax court to address this issue in the first instance. We express no view the question whether the Commissioner is applying the regulation retroactively in this case.

REVERSED AND REMANDED.

HUG, Circuit Judge, Dissenting:

I respectfully dissent. I would affirm the judgment of the Tax Court based upon the well-reasoned opinion of Judge Wells writing for the majority of the Tax Court. *Pacific First Federal Savings Bank v. CIR*, 94 U.S. Tax Court Reports 96 (1990).

PACIFIC FIRST FEDERAL SAVINGS BANK, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 27606-87. Filed February 27, 1990.

From 1971 through 1980, P deducted additions to its bad debt reserve. The amounts deducted were calculated with reference to P's taxable income for each year. In 1981 and 1982, P had net operating losses (NOLs). *Held*, subdivisions (vi) and (vii) of sec. 1.593-6A(b)(5), Income Tax Regs., are invalid to the extent they require that taxable income reflect any NOL carrybacks before the deduction for addition to bad debt reserve is calculated for certain financial institutions.

Alan S. Kaden and *John F. Coverdale*, for the petitioner.
Fera Wagner and *Richard Osborne*, for the respondent.

OPINION

WELLS, *Judge:* Respondent determined the following deficiencies in petitioner's Federal income tax:

Year	*Deficiency*
1978	$1,743,066
1979	5,057,885
1980	2,512,321

After concessions, the issue presented is whether certain portions of section 1.593-6A(b)(5)(vi) and (vii), Income Tax Regs., are valid. For certain financial institutions, including petitioner, the deduction for addition to bad debt reserve is generally equal to a percentage of the financial institution's taxable income. The challenged portions of the regulation require that taxable income reflect any net operating loss carrybacks before the deduction for addition to bad debt reserve is calculated.

The facts are fully stipulated. We incorporate by reference the stipulation of facts and attached exhibits.

Petitioner is a corporation formed and existing under the laws of the State of Washington and having as its principal place of business when it filed its petition Tacoma, Washington.

From 1971 through 1980, petitioner used the calendar year as its taxable year and deducted amounts added to a reserve for bad debts. Petitioner calculated those amounts by using the "percentage of taxable income method" set forth in section 593(b)(2)(A).[1] For those years, section 166(c) permitted taxpayers to deduct a "reasonable addition" to bad debt reserve, in lieu of specific debts as they became worthless. Section 593(b) defined the term "reasonable addition" for certain financial institutions, including petitioner. Under that subsection, the deduction for addition to reserve with respect to "qualifying real property loans" (generally those loans secured by improved real property (sec. 593(d))) was subject to various limits, one of which was set forth in section 593(b)(2)(A). That provision limited the deduction to "the applicable percentage of the taxable income" for the year.[2]

[1]Unless otherwise indicated, all section references are to the Internal Revenue Code as amended and in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2]During relevant times, the portions of section 593 pertinent to the instant case provided as follows:

SEC. 593(b). ADDITION TO RESERVE FOR BAD DEBTS.—

(1) IN GENERAL.—For purposes of section 166(c), the reasonable addition for the taxable year to the reserve for bad debts * * * shall be an amount equal to the sum of—

* * * * * * *

BEST AVAIL

In 1981 and 1982, petitioner had net operating losses (NOLs) within the meaning of section 172(c) in the amounts of $43,459,246 and $27,748,382, respectively. Under section 172(b)(1)(F), those NOLs may be carried back to each of the 10 taxable years preceding the loss years.

Central to resolution of the instant case is the interplay between NOL carrybacks and the deduction for addition to bad debt reserve calculated under the percentage of taxable income method. Respondent contends that petitioner's NOL carrybacks from 1981 and 1982 reduce petitioner's deductions under section 593(b)(2)(A) for 1971 through 1977 by reducing the "taxable income" base used in calculating the deduction for each of those years. As a consequence, according to respondent, a larger portion of the 1981 and 1982 NOLs are "absorbed" by the increase in taxable income for 1971 through 1977, and a smaller portion of the NOLs remains available for the years in issue, i.e., 1978, 1979, and 1980. Deficiencies result for these years, according to respondent, because section 172(a) deductions are reduced or eliminated. In other words, respondent advocates an ordering rule which, under the facts of this case, results in faster absorption of NOLs.

Subdivisions (vi) and (vii) of section 1.593-6A(b)(5), Income Tax Regs., support respondent's position. The provisions

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(B) the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans, but such amount shall not exceed the amount determined under paragraph (2), (3), or (4) whichever amount is the largest. * * *

* * * * * * *

(2) PERCENTAGE OF TAXABLE INCOME METHOD.—

(A) IN GENERAL.— * * * the amount determined under this paragraph for the taxable year shall be an amount equal to the applicable percentage of the taxable income for such year (determined under the following table):

For a taxable year beginning in—	*The applicable percentage under this paragraph shall be—*
1971	54%
1972	51
1973	49
1974	47
For a taxable year beginning in—	*The applicable percentage under this paragraph shall be—*
1975	45
1976	43
1977	42
1978	41
1979 or thereafter	40

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generally require that taxable income reflect any NOL carrybacks *before* the deduction for addition to bad debt reserve is calculated. Specifically, the pertinent portions of the regulation provide as follows:

> (5) *Computation of taxable income.* For purposes of * * * [calculating the deduction for addition to bad debt reserve under the percentage of taxable income method], taxable income is computed—
>
> * * * * * * *
>
> (vi) For taxable years beginning before January 1, 1978, without regard to any deduction the amount of which is computed upon, or may be subject to a limitation computed upon, the amount of taxable income, and without regard to any net operating loss carryback to such year from a taxable year beginning before January 1, 1979. (For purposes of this subparagraph, a net operating loss deduction under section 172 is not a deduction the amount of which may be subject to a limitation computed upon the amount of taxable income.)
>
> (vii) For taxable years beginning after December 31, 1977, by taking into account any deduction the amount of which is computed upon, or may be subject to a limitation computed upon, the amount of taxable income, and any other deduction or loss allowed under subtitle A of the Code, such as any deduction allowable under section 172 or any loss allowable under section 1212(a), unless otherwise provided in this subparagraph.

For taxable years beginning after December 31, 1977, subdivision (vii) expressly requires that taxable income reflect the section 172(a) deduction prior to calculating the deduction for addition to bad debt reserve. For taxable years beginning before January 1, 1978, subdivision (vi) requires, by negative implication, that taxable income reflect NOL carrybacks from years beginning after December 31, 1978, prior to calculating the deduction. As originally promulgated on May 17, 1978, the ordering rule was to affect only taxable years beginning after December 31, 1977. T.D. 7549, 1978-1 C.B. 185, 186. Proposed amendments to the regulation would have required retroactive use of the ordering rule for NOL's occurring after 1977 (43 Fed. Reg. 60964 (Dec. 29, 1978)), but the regulation was amended on May 31, 1979, to have retroactive effect only for NOL's occurring after 1978. T.D. 7626, 1979-2 C.B. 239, 240.

Petitioner argues that the foregoing provisions are invalid and that it should be permitted to use the ordering rule in effect prior to publication of the regulation containing the challenged provisions on May 17, 1978. The ordering rule

proposed by petitioner requires calculation of the deduction for addition to bad debt reserve *before* any NOL carrybacks are reflected in the calculation of taxable income.

Prior to May 17, 1978, the applicable Treasury regulations were consistent with petitioner's method. They required or were interpreted to require that NOL carrybacks be disregarded when using the percentage of taxable income method to calculate the deduction for addition to bad debt reserve. The first regulations interpreting section 593 provided as follows:

> the reasonable addition to a reserve for bad debts shall be an amount determined by the taxpayer which does not exceed the lesser of:
>
> (1) The amount of its taxable income for the taxable year, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), * * * [Sec. 1.593-1(b)(1), Income Tax Regs. (1956).]

Respondent cited the foregoing regulation in a revenue ruling which required that NOL carrybacks be disregarded when computing the deduction for addition to bad debt reserve. Rev. Rul. 58-10, 1958-1 C.B. 246, 247.

After the Revenue Act of 1962 amended section 593, a new regulation was published that was more explicit than the original regulation. The new regulation provided that taxable income (for the purpose of calculating the deduction for addition to bad debt reserve under the percentage of taxable income method) should be calculated "without regard to any net operating loss carryback to such year under section 172." Sec. 1.593-6(b)(2)(iv), Income Tax Regs. (1964).

Thus, the provisions challenged by petitioner reversed an ordering rule that had been in effect for approximately 20 years. The following hypothetical example highlights the difference between the positions of the parties:

	1971	*1972*	*1981*
(1) Income before percentage method deduction	1,000,000	1,000,000	(1,000,000)
(2) Percentage method deduction at 54% for 1971 and 51% for 1972	(540,000)	(510,000)	---

	1971	*1972*	*1981*
(3) Taxable income before carrybacks	460,000	490,000	(1,000,000)
(4) Tax at 46%	211,600	225,400	---
Carryback Effect Under Prior Regs. (Petitioner's Position):			
(5) Taxable income before carryback	460,000	490,000	---
(6) NOL carryback absorbed	(460,000)	(490,000)	---
(7) Tax	---	---	---
(8) Refund due to carryback	211,600	225,400	---
(9) NOL carried to next year	(540,000)	(50,000)	---
Carryback Effect Under Challenged Rule (Respondent's Position):			
(10) Taxable income before carryback	460,000	Loss fully absorbed in 1971. Lines (1)-(4) above are unaffected.	
(11) Add back percentage[3] method deduction	540,000		
(12) Subtotal	1,000,000	---	---
(13) NOL carryback absorbed	(1,000,000)	---	---
(14) Tax	---	---	---
(15) Refund	211,600	---	---
(16) NOL carried to next year	---	---	---

The challenged provisions were promulgated under the authority of section 7805(a), which authorizes the Secretary of the Treasury to "prescribe all needful rules and regulations for the enforcement of this title." Consequently, while the challenged provisions are entitled to deference, they are not entitled to as much deference as that owed to "legislative regulations," which are promulgated under more specific grants of authority. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982).

In *National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472, 477 (1979), the Supreme Court set forth the following guidelines for adjudging the validity of an interpretative regulation:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation

[3]The example ignores, for the sake of simplicity, that the taxpayer may be entitled to a deduction under an alternative method, such as the experience method, even if lack of "taxable income" prevents a deduction under the percentage method.

harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.

With the foregoing precepts in mind, we hold that the challenged portions of section 1.593-6A(b)(5)(vi) and (vii), Income Tax Regs., are invalid.

Plain Language of the Statute

Respondent contends that the plain language of the statute compels the ordering rule set forth in the challenged provisions. Respondent points out that section 593(b)(2)(A) limits the deduction for addition to bad debt reserve to a percentage of "taxable income"; that "taxable income" is defined in section 63 as gross income less the deductions allowed by Chapter 1, including the section 172(a) deduction for NOL's; that section 593(b)(2)(E) prescribes certain modifications to "taxable income," none of which involve section 172(a); and that, therefore, taxable income must reflect NOL carrybacks before the deduction for addition to bad debt reserve is calculated. Respondent also points out that various sections other than section 593, such as sections 170, 246, and 613A, expressly modify the section 63 definition of taxable income by excluding NOL carrybacks, while section 593(b)(2)(E) does not.

Respondent's argument presumes that section 593(b)(2)(E) sets forth an exclusive list of modifications to the section 63 definition of taxable income. Legislative history, however, can be used as an aid to construing even those statutes that appear clear. *United States v. American Trucking Assns.*, 310 U.S. 534, 543-544 (1940) ("When aid to construction of the meaning of words, as used in the statute, is available, there certainly can be no 'rule of law' which forbids its use, however clear the words may appear on 'superficial examination.' " (fn. ref. omitted)). The legislative history of section 593 discussed *infra* indicates that

respondent's interpretation is incorrect and that the statute is not free of ambiguity.

Origin and Purpose of the Statute

Moreover, we reject any suggestion that our inquiry is limited to the statutory language. *National Muffler Dealers Assn., Inc. v. United States* requires that a challenged regulation be examined for consistency with "the statute, its origin, *and* its purpose." *Supra* at 477 (emphasis supplied). When assessing the validity of a regulation, the Supreme Court has focused upon the will of Congress, rather than limiting the inquiry to the statutory language. In *United States v. Vogel Fertilizer Co., supra* at 26, the Supreme Court stated, "This Court has firmly rejected the suggestion that a regulation is to be sustained simply because it is not 'technically inconsistent' with the statutory language, when that regulation is fundamentally at odds with the manifest Congressional design."

Prior to 1952, certain financial institutions were exempt from Federal income tax. Exempt from taxation were "a mutual savings bank not having capital stock represented by shares," "a domestic building and loan association," and "a cooperative bank without capital stock organized and operated for mutual purposes and without profit" (Hereafter, we refer to the foregoing types of financial institutions as mutual institutions.). Secs. 101(2), (4), (15), I.R.C. 1939.

The Revenue Act of 1951 repealed the tax-exempt status of mutual institutions, but also granted them a generous deduction for addition to bad debt reserve. In fact, Congress amended section 23(k)(1) of the Internal Revenue Code of 1939 to permit mutual institutions to deduct as much as "net income for the taxable year, computed without regard to * * * [the deduction]," so long as the resulting reserve combined with surplus and undivided profits did not exceed 12 percent of "total deposits or withdrawable accounts." Sec. 313(e), ch. 521, 65 Stat. 490. Thus, Congress wanted to terminate the "substantial tax savings" enjoyed by mutual institutions, but, at the same time, sought to encourage ample reserves through the deduction for addition to bad

debt reserve. S. Rept. 781, 82nd Cong., 1st Sess. (1951), 1951 C.B. 458, 474.

The Revenue Act of 1962 somewhat curtailed the available deduction. Congress amended section 593 to permit mutual institutions to deduct "reasonable addition[s]" to reserves for "nonqualifying loans" (generally those loans not secured by improved real property (sec. 593(d))) as well as additions to reserves for "qualifying real property loans." The latter amount generally could equal the greater of (1) 60 percent of taxable income less the amount added to the reserve for nonqualifying loans, (2) an amount necessary to increase the reserve for qualifying real property loans to 3 percent of such loans, or (3) an amount based upon loss experience. For purposes of calculating the deduction under the percentage of taxable income method, the amended statute provided,

> taxable income shall be computed (i) by excluding from gross income any amount included therein by reason of subsection (f) [pertaining to distributions from reserve to shareholders], and (ii) without regard to any deduction allowable for any addition to the reserve for bad debts.

The addition calculated under the percentage of taxable income method could not produce a reserve for qualifying real property loans greater than 6 percent of such loans. As before, total reserves combined with surplus and undivided profits could not exceed 12 percent of deposits. Pub. L. 87-834, sec. 6(a), 76 Stat. 977.

The House Report expresses Congress' dual concerns in enacting the foregoing changes. On one hand, Congress sought to tax mutual institutions. The report states, "Congress repealed [in 1951] the exemption of these mutual savings institutions * * * . At the same time, however, these institutions were allowed a special deduction for additions to bad-debt reserves which proved to be so large that they have remained virtually tax exempt since 1951." On the other hand, Congress wanted to ensure that ample reserves would be maintained and therefore preserved a generous deduction for additions to reserve. The report states, "The bill provides reserves consistent with the proper protection of the institution and its policyholders in the light of the peculiar risks of long-term lending on residential real estate which is the principal function of

these institutions." H. Rept. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 436-437.

The Tax Reform Act of 1969 further curtailed the available deduction. Amendments to section 593 eliminated the method of calculating the deduction that had permitted mutual institutions to deduct an addition necessary to bring the bad debt reserve for qualifying real property loans to 3 percent of such loans. The percentage of taxable income method was modified by reducing the allowable deduction from 60 to 40 percent of taxable income over a 10-year period. Congress also further modified the method of calculating taxable income for section 593 purposes. Amendments required the exclusion of (1) net gain from dealings in corporate stock or tax-exempt obligations, (2) the lesser of 3/8 of net long-term capital gain or 3/8 of such gain from dealings in property other than that described in the first exclusion,[4] and (3) dividends giving rise to a dividends-received deduction less the "applicable percentage" of the deduction. Meanwhile, Congress extended the NOL carryback period from 3 to 10 years for mutual institutions and commercial banks. Pub. L. 91-172, secs. 431(b), 432(a), 83 Stat. 619, 620.

Legislative history indicates that Congress again struggled with competing considerations in enacting the foregoing changes. As in 1962, Congress believed that mutual institutions were paying less than a fair amount of tax. The House Report states:

> Your committee has reviewed the tax treatment of these mutual institutions. It has concluded that the present bad-debt reserve provisions are unduly generous as they have allowed these institutions to pay a much lower average effective rate of tax than the average effective rate for all corporations. * * * [H. Rept. 91-413, 1969-3 C.B. 200, 278.]

Yet, as in 1962, Congress' desire to ensure that mutual institutions pay taxes was counterbalanced to some extent by Congress' goal of encouraging reserves. Thus, the House Report explains:

> Your committee believes, that, notwithstanding a larger tax liability because of these changes in the bad-debt reserve deductions, there will

[4] Technical corrections to the Revenue Act of 1978 increased the percentage to 18/46. Pub. L. 96-222, sec. 104(a)(3)(C), 94 Stat. 215.

still be reserves consistent with the proper protection of the institution and its policyholders in the light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions. Furthermore, to provide for unusually large losses, your committee has extended the net operating loss carryback from 3 to 10 years for all financial institutions, which allows the spreading of losses over 15 years—10 years back and 5 years forward. Your committee believes that this is a better means to provide for large unexpected losses than to allow such institutions to build up their reserves tax free. [H. Rept. 91-413, 1969-3 C.B. at 278.]

The House Report also contains a number of statistics, including the following:

Tax as a percent of economic income:	*1966*
A. Commercial banks	23.2
B. Mutual savings banks	6.1
C. Savings and loan associations	16.9

In response to the foregoing statistics, the House Report comments:

Since your committee's bill increases appreciably the 23.2 percent effective rate of tax for commercial banks, it is your committee's intention not only to bring the level of taxation of mutual savings banks (presently 6.1 percent) up to the level of savings and loan associations (16.9 percent), but also to provide an increase in the 16.9 percent rate somewhat comparable to the increase in the 23.2 percent rate for commercial banks. For this reason, the percentage deduction for additions to bad-debt reserves is being reduced from 60 percent to 30 percent, but this reduction is to take effect over a 10-year period. This percentage reduction in the formula will raise the effective rate of tax for these institutions, but will still leave some margin of tax advantage for them over commercial banks, which should preserve the inducement for them to continue investing in real estate mortgages. [H. Rept. 91-413, 1969-3 C.B. at 278.]

Thus, the House was cognizant of the effective rate of tax paid by mutual institutions and intended to raise, *but only to a specific and limited extent*, that effective rate by reducing the deduction for addition to bad debt reserve.

Moreover, while the House proposed to reduce the applicable percentage used under the percentage of taxable income method from 60 to 30 percent over 10 years, the Senate proposed a reduction to only 50 percent over 4 years. The Senate, like the House, was aware of the

effective rate of tax paid by mutual institutions (S. Rept. 91-552, 1969-3 C.B. 423, 526) and felt that a smaller increase in that effective rate was proper. The Senate Report states, "The committee believes that the reduction to 50 percent represents a sufficient increase in taxes for these mutual institutions at this time." S. Rept. 91-552, 1969-3 C.B. at 526. As noted, Congress ultimately decided to reduce the applicable percentage to 40 percent over 10 years.

The ordering rule found in the challenged portions of section 1.593-6A(b)(5)(vi) and (vii), Income Tax Regs., does not harmonize with Congressional intent. First, the effect of the new ordering rule (proposed in 1971 (36 Fed. Reg. 15050 (Aug. 12, 1971))) is to curtail the deduction for addition to bad debt reserve after Congress had already curtailed the deduction in 1969 and consciously rejected a proposal for a greater curtailment. In 1969, both the House and the Senate were aware of the effective rate of the tax paid by mutual institutions and sought to increase that effective rate to different, specific extents. In conference, Congress reached a compromise, deciding upon an increase greater than that proposed by the Senate but less than that sought by the House. The new ordering rule curtails the deduction for addition to bad debt reserve by contracting the taxable income base to which the applicable percentage is applied. The new ordering rule thereby increases the effective rate of tax for mutual institutions beyond the extent intended by Congress.

Second, the new ordering rule reduces the value of NOL carrybacks and is therefore plainly at odds with Congress' intent to ameliorate the effects of the 1969 curtailment by granting mutual institutions a "more generous net operating loss carryback." H. Rept. 91-413, 1969-3 C.B. at 280. When Congress extended the NOL carryback period from 3 to 10 years in 1969, it was well established that NOL carrybacks had no effect on deductions for additions to bad debt reserve for carryback years. The regulations so provided and there was no contrary authority specifically addressing the interplay between NOL carrybacks and the sections 166 and 593 deduction. Congress amended both (1) the bad debt reserve deduction provisions and (2) the net

operating loss carryback provisions in order to achieve a limited increase in the income tax levels of mutual institutions. In order to determine the effect of proposed changes and, if necessary, to modify the changes, Congress must have examined the then-effective regulations and concluded that those regulations correctly reflected Congress' intent as to how NOL carrybacks were to affect deductions for additions to bad debt reserve. Under the ordering rule of the later regulations, however, a carryback results in a "recapture," in effect, of a portion of the deduction for addition to bad debt reserve for the carryback year. As much as 60 percent (the applicable percentage for 1969) of a carryback is offset by a corresponding reduction in the deduction for addition to bad debt reserve. The full benefit Congress intended by its action in 1969 is thereby denied.

The legislative history also indicates that Congress did not intend that section 593(b)(2)(E) provide the exclusive list of modifications to the section 63 definition of taxable income. In both 1962 and 1969, Congress modified the method of calculating taxable income for section 593(b)(2)(A) purposes. In both years, Congress specified certain modifications to the section 63 definition of taxable income. Congress never, however, expressed any indication that pre-existing, regulatory, or administrative modifications to the section 63 definition (such as the prior ordering rule) were to be repealed and replaced by an exclusive, statutory list. Prior to the 1962 amendments, Revenue Ruling 58-10, 1958-1 C.B. 246, had construed section 1.593-1(b)(1), Income Tax Regs. (1956), as requiring the disregard of NOL carrybacks when calculating the deduction for addition to bad debt reserve. Prior to the 1969 amendments, section 1.593-6(b)(2)(iv), Income Tax Regs. (1964), had explicitly required that NOL carrybacks be ignored when calculating the deduction. Had Congress intended to supplant those and other administrative and regulatory modifications of the section 63 definition, we believe that some definite indication of such intent would appear in the legislative history. The complete absence of any indication that Congress intended to supplant such modifications of the section 63 definition is proof that Congress merely intended to enact

the modifications specifically dealt with in the statutory language.[5]

Further proof that Congress intended that pre-existing modifications remain in effect is the fact that any modification of the taxable income base would upset the legislative compromise reached in 1969. Contracting the base would result in a greater curtailment of the deduction for addition to bad debt reserve, while expanding the base would neutralize in whole or in part the curtailment approved by Congress.

Finally, the statute itself does not state that its list of modifications is exclusive. We also note that when Treasury initially proposed the new ordering rule, it supported the change by arguing that Congress had enacted an exclusive, statutory list of modifications to the section 63 definition in 1969. Respondent, however, has essentially discarded this argument, perhaps because of lack of confidence in its merit.

Other Considerations

Other factors set forth in *National Muffler Dealers Assn., Inc. v. United States* support our conclusion. 440 U.S. at 477. Although neither the challenged provisions nor the earlier ordering rule fairly can be characterized as "substantially contemporaneous constructions" of section 593 (see *United States Trust Co. v. Internal Revenue Service*, 803 F.2d 1363, 1370 (5th Cir. 1986)), the earlier ordering rule was promulgated much closer to the enactment of section 593's predecessor in 1951. The 1956 regulation had been proposed in 1955. 20 Fed. Reg. 7992 (Oct. 25, 1955). Although section 593's predecessor based the deduction on "net income," the regulation promulgated in 1964 expressly provided for the disregard of NOL carrybacks when calculating the deduction and was promulgated after the statute had been changed to refer to "taxable income." The manner in which the challenged provisions evolved also supports

[5]Because petitioner did not argue the reenactment doctrine (*Helvering v. Winmill*, 305 U.S. 79, 83 (1938)), we do not address the impact of the doctrine on Treasury's authority to promulgate the challenged provisions. Compare *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939) (Congressional approval of long-standing regulation precluded retroactive enforcement of amended regulation taking contrary position) and *Helvering v. Griffiths*, 318 U.S. 371 (1943) (reenactment doctrine cannot invalidate reasonable, prospective amendments to regulations).

our conclusion, as the provisions reversed a long-standing, consistent interpretation of the relevant statute.

We are mindful of the rule enunciated in cases such as *United States v. Southwestern Cable Co.*, 392 U.S. 157, 170 (1968): "the views of one Congress as to the construction of a statute adopted many years before by another Congress have 'very little, if any, significance.'" Accord *United States v. American College of Physicians*, 475 U.S. 834, 846-847 (1986); *Rainwater v. United States*, 356 U.S. 590, 593 (1958); *Mars, Inc. v. Commissioner*, 88 T.C. 428, 435 (1987) (refusing to consider Congressional intent behind amendments to section 367 which were not effective for transaction in issue). We do not believe, however, that the rule affects our conclusion. We do not rely upon the views of Congress in 1969 to construe an earlier enactment. Rather, our inquiry has been whether the challenged provisions harmonize with the intent behind section 593(b)(2), as amended by the Tax Reform Act of 1969, and in effect from 1971 through 1980, the years petitioner deducted additions to bad debt reserve.

That a regulation harmonizes with an extinct ancestor of a statute, and its purpose, should not suffice. In *National Muffler Dealers Assn., Inc. v. United States*, the Court considered a 1966 amendment to section 501(c)(6) in attempting to decide whether regulations interpreting "business league," a term first used in the Tariff Act of October 3, 1913, comported with Congressional intent. 440 U.S. at 478-479, 487. Also in *United States v. Vogel Fertilizer Co.*, 455 U.S. at 35, the Court stated, "it is the intent of the Congress that *amended* section 1563(a), not the views of the subsequent Congress that enacted section 414, that are controlling." (Emphasis supplied.) Thus, while the *views* of Congress respecting earlier enactments are given little weight, regulations must square with the purpose of a statute as it exists for the period in issue.

Respondent points out that the challenged provisions had been in effect for approximately 8 years when Congress amended section 593 as part of the Tax Reform Act of 1986. Respondent argues that Congress approved the ordering rule prescribed by the challenged provisions by reducing the applicable percentage to 8 percent without reverting

back to the old ordering rule. Pub. L. 99-514, sec. 901(b), 100 Stat. 2378. We find respondent's argument unconvincing. Assuming arguendo that the reenactment doctrine gave the challenged provisions the force of law in 1986, there is no indication that Congressional approval was retroactive. In *Helvering v. R.J. Reynolds Tobacco Co., supra*, the Court faced a scenario very similar to the one before us. A long-standing regulation provided that corporations did not recognize income from dealings in their own stock. Treasury then reversed its position, and respondent attempted to apply the new rule retroactively. The Court held for the taxpayer, reasoning that the earlier regulation had acquired the force of law. In response to respondent's argument that the new rule also had received Congressional approval, the Court stated:

> But we have no occasion to decide this question since we are of opinion that the reenactment of the section, without more, does not amount to sanction of retroactive enforcement of the amendment, in the teeth of the former regulation which received Congressional approval, by the passage of successive Revenue Acts including that of 1928. [306 U.S. at 117.]

Respondent argues that unless NOL-adjusted taxable income is the basis for computing the deduction for addition to bad debt reserve, mutual institutions will create reserves out of deposits, rather than income, as contemplated by Congress. Respondent has failed to demonstrate that Congress was concerned that additions to reserve be made from income. In fact, section 593, as in effect for the relevant period, refutes respondent's contention, as it permitted additions to bad debt reserve based upon loss experience, without regard to taxable income. Sec. 593(b)(4).

Furthermore, the prior ordering rule does not enable petitioner or other mutual institutions to obtain "double deductions." Under the reserve method of accounting for bad debts, additions to a reserve for bad debts are deducted from income. No deduction is made, however, when an individual debt is deemed worthless. Rather, the reserve is charged in the amount of the debt. Conversely, the reserve is credited for debts collected after having been deemed worthless. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 547 (1979); *Black Motor Co. v. Commissioner*, 41 B.T.A. 300, 302 (1940), affd. 125 F.2d 977 (6th Cir. 1942).

To the extent mutual institutions receive some untoward benefit by using the percentage of income method for calculating their deductible addition in profitable years while shifting to a loss experience method after suffering losses, we respond by noting that Congress has given mutual institutions such latitude. Sec. 593(b)(1)(B).

To reflect the foregoing and concessions,

Decision will be entered under Rule 155.

Reviewed by the Court.

NIMS, CHABOT, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, WRIGHT, WILLIAMS, and COLVIN, *JJ.*, agree with the majority opinion.

WHALEN, *J.*, concurs in the result only.

GERBER, *J.*, dissenting. I respectfully disagree with those who support the majority's opinion because they have chosen to invalidate a regulation which is a literal, accurate, and reasonable interpretation of unambiguous statutory provisions. This matter arose in circumstances under which respondent issued new regulations contrary to his original regulations and position. The superseded regulations had permitted the result being sought by petitioner. Although the majority has not shown that the new regulations are incompatible with the statutory structure, it has invalidated the regulation because of its perception of congressional intent. I cannot support the majority's holding because: (1) The regulations are unambiguous and in complete accord with an unambiguous statutory framework; (2) the effect of the majority's invalidation of the regulations will not carry out the congressionally intended result described in the majority opinion; (3) it permits a congressionally unintended benefit to a specific class of taxpayers, which is not available to any other class of taxpayers; and (4) the majority has failed to consider the Supreme Court's analysis and approach in an analogous and similarly situated case.

Background

The salient factors in this case are as follows:

(1) Petitioner is a savings bank which computes its reserve for losses under section 593. "This section * * * permits a taxpayer broad discretion to determine the amount of the addition to [its] reserve, not to exceed the limits set forth in section 593(b)." *The Home Group, Inc. v. Commissioner*, 91 T.C. 265, 266 (1988), affd. on other grounds 875 F.2d 377 (2d Cir. 1989).

(2) Petitioner, during the taxable years 1971 through 1977, could have chosen any of several statutorily permitted methods of computing its loss reserve. Some of the methods provide for computation of the reserve based upon actual experience. Another permits the use of an artificial statutorily permitted percentage of taxable income without regard to a taxpayer's actual loss experience. Petitioner, for its 1971 through 1977 taxable years, used the artificial percentage of taxable income method without regard to its actual loss experience to produce the largest permissible reduction of taxable income—a result envisioned by Congress to permit the flow of additional capital and provide for potential losses.

(3) As much as 10 years later, in 1981 and 1982, petitioner experienced net operating losses which generated a net operating loss deduction (NOLD), which petitioner sought to carry back to the taxable years 1971 through 1977. The NOLD reduces taxable income and may produce a tax refund from the years to which it is carried back. To the extent that the NOLD is not absorbed in the year to which it is carried back, it is carried forward to the next later year with taxable income, and so on. Petitioner wishes to have the benefit of being able to carry the NOLD further forward by applying it against an amount of taxable income in the carryback year which had been reduced by the maximum amount of reserve addition based upon a "taxable income" unreduced by the NOLD. In other words, petitioner wishes us to ignore the fact that taxable income had been reduced in the carryback year by an addition to the loss reserve based upon a percentage of taxable income. Respondent argues that taxable income must first be reduced by the NOLD before the reserve addition may be determined. It should be noted that respondent does not advocate that petitioner receive no allowance for its loss

reserve, but that it is not now feasible to compute it based upon the now-reduced amount of taxable income under the computation called for in the questioned regulation. It should also be noted that section 593 provides for alternative methods to compute an addition to the loss reserve without the percentage of taxable income limitation.

The appropriate question posed by these facts is whether petitioner is entitled to the double benefit of carrying back the NOLD and also retaining the artificial and purely mathematical addition to its loss reserve based upon the "pre-NOLD" or unreduced amount of taxable income.[1] The answer to this question is to be found in the definition of the term "taxable income." "Taxable income" is conceptually the bedrock of our income tax system. We must be careful not to weaken this structure by an inconsistent use of the basic principles which have been carefully formulated over the past 75 years. The majority has not shown or stated that the regulations[2] it invalidates do not comport with statutes (which are unambiguous on their face). The majority opinion is based upon a view that Congress intended a result opposite to that promulgated in respondent's regulation, even though the statutory provisions clearly and unambiguously comport with respondent's regulation. The majority also emphasizes respondent's 20-year practice of permitting the double benefit prior to promulgation of the regulation in question.[3]

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[1]This is a double benefit because it would permit the benefits of the NOLD and the unreduced loss reserve at the same time. These benefits may both exist only if inconsistent concepts of taxable income are used. Moreover, as explained *infra*, the NOLD and addition to the loss reserve represent concepts which Congress intended to be inversely proportional, so that if one is larger, the other, by design, must be smaller. Here petitioner seeks for them both to be utilized without considering the other.

The record is silent on whether petitioner's particular accounting method with regard to reporting of actual losses or recoveries could result in the potential for double deductions. For purposes of this discussion it is assumed that the question of potential double deductions is not involved and should not be considered.

[2]The regulations require the reduction of taxable income by NOLD's and the recomputation of the addition to the reserve based upon the reduced amount of taxable income. In a recent opinion we held that taxpayers were permitted broad discretion to choose among the various methods for computing their reserve under sec. 593. *The Home Group, Inc. v. Commissioner*, 91 T.C. 265 (1988), affd. on other grounds 875 F.2d 377 (2d Cir. 1989). In that Court-reviewed opinion we permitted a taxpayer to select the method it wished for a 1969 taxable year during a 1988 controversy over the computation of a deficiency under Rule 155 of our Rules of Practice and Procedure.

[3]Respondent's inconsistent positions, whether expressed in revenue rulings or contained in superseded regulations, should be afforded little or no weight. To give credence to respondent's longstanding positions as a basis for holding a regulation valid or invalid, if

Congressional Intent

The majority has expended substantial verbiage attempting to persuade us that Congress intended certain savings institutions to enjoy liberal loss reserves, which may result in the freeing of capital. To that extent, there is no disagreement. The disagreement concerns the majority's reasoning that these intentions are a basis for holding that certain savings institutions should have a more favorable definition or concept of "taxable income" applied to them in instances where they are carrying back a NOLD. No legislative history has been advanced by the majority for such a proposition and the statutes involved, as the majority must admit, do not provide for such a result. The essence of the legislative history advanced by the majority tells us that Congress intended that certain savings institutions, which were once tax-exempt, should be subject to taxation; and that said institutions were originally intended to have broad discretion to enjoy liberal deductions attributable to their loss reserves.

The majority also refers us to the legislative history for the undisputed proposition that the 10-year net operating loss carryback was intended as a substitute for permitting larger loss reserves. This proposition is more properly cited in support of this dissenting view that Congress did not intend to permit both the largest possible reserve and 7 additional years within which to carry back subsequent losses, as petitioner is seeking and the majority has approved in this case. The position advanced by petitioner and approved by the majority is inconsistent with congressional intent concerning the relationship between the 10-year carryback and the more generous percentage of taxable income loss reserve allowance. Therein lies the incongruity and shortcoming of the majority's logic.

If these institutions are to be subject to tax, the definition of "taxable income" utilized for them should be no different than the definition used for other taxpayers, unless specifically and congressionally mandated otherwise.

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equally applied in other settings, may place us in a position of treating respondent's longstanding positions as correct by means of prescriptive preemption. If the regulations in question comport with the statute and congressional intent, should they be invalidated because of respondent's longstanding position or interpretation to the contrary?

Here, in the face of unambiguous statutory provisions, the majority would redefine "taxable income" based upon its own rationalized view of inexplicit congressional intent. It is inappropriate to find an otherwise lucid statute(s) to be ambiguous based upon legislative history (assuming such legislative history existed here).[4] Furthermore, it seems inappropriate to look to legislative history underlying prior statutory provisions when Congress has reenacted the provisions in question at a time when the questioned regulations had been published for nearly 8 years—a point for which the majority has already provided ample case support.

Congressional intent to expand or increase reserves or the amount of capital available for loans was fully served in this case. Throughout the period that ended with the net operating loss, petitioner received the benefit of computing its loss reserve allowance based upon a percentage of taxable income unreduced by the NOLD now in issue. By means of the beneficial computation in each of the years 1971 through 1977, petitioner ostensibly reported less taxable income and had more cash to loan while amassing a larger reserve for losses. The current recomputation of a portion of the addition to the reserve does not change the availability of that cash which was likely received by borrowers long before petitioner experienced a net operating loss in the 1980's. The only direct effect of the current recomputation is to determine the amount of the net operating loss deduction to be absorbed and, hence, the amount of any refund due the taxpayer. The recomputation, as it relates to the allowance for losses and the loss reserve, has no effect on the congressionally intended result.

Moreover, the congressional intent underlying the net operating loss deduction is also fully served by the ability of petitioner to seek refunds or reductions of tax liability from "carryback years" which would be currently available for the congressionally intended purpose of making capital

[4]The majority has proceeded a step beyond using the legislative history to assist in understanding a statutory provision. Indeed, without a supporting statutory provision or an ambiguity in the one the regulation tracks, the majority has devised a self-serving version of congressional intent. Commentators have cautioned us to be leery of congressional commentary even where it directly addresses the statutory matter. See Justice Scalia's comments in his concurring opinion in *Blanchard v. Bergeron*, 489 U.S. 87, 97 (1989).

available to the taxpayer who suffered the net operating loss. Here, however, petitioner, in addition to the favorable reserve benefits already received and those still available, asks us to use differing definitions of "taxable income" to provide to it benefits beyond those congressionally mandated. The concept of net operating losses is not unique to petitioner, as is the loss reserve addition permitted by Congress, and we cannot permit special treatment in an area involving a universal concept (like net operating losses or taxable income) without a clear and specific congressional mandate. As pointed out by the majority, the extra benefit relative to operating losses that Congress conferred upon these savings institutions was to permit a 10-year, rather than a 3-year, carryback. No additional benefit is described or should be inferred, including the one sought by petitioner in this case.

The Double Benefit Aspect

The circumstances of this case have a direct and correlative relationship to the situation we considered in *The Home Group, Inc. v. Commissioner*, 91 T.C. 265 (1988), affd. on other grounds 875 F.2d 377 (2d Cir. 1989). That case also involved the computation of the addition to the loss reserve provided for in section 593. In that case, we permitted a taxpayer to make a choice concerning the amount of loss reserve to utilize because taxable income had increased due to a deficiency resulting from another matter decided adversely to that taxpayer, and hence the possibility for a larger reserve. Here we are confronted with a mirror image situation—the taxable income is reduced by a NOLD and the reserve addition (which is an element necessary to arrive at taxable income) should also be automatically reduced in accord with the statutory and regulatory formula for its computation.

Failure to reduce the loss reserve addition would result in the anomaly of no taxable income in a particular year and a large increase to the reserve for losses based upon a now-fictional amount of taxable income. Because the addition to the reserve results in a deduction used to arrive at taxable income, distortion and incongruity must result. Where a taxpayer's taxable income increases due to events

occurring subsequent to the taxable year in question, that taxpayer's addition to the loss reserve could increase. *The Home Group, Inc. v. Commissioner, supra.* Where a taxpayer's taxable income is to be decreased due to events occurring subsequent to the taxable year in question, pursuant to the majority's holding, that taxpayer's addition to the loss reserve would not be reduced.

Moreover, the majority has failed to emphasize (having relegated it to footnote 3 of the majority opinion) that, under respondent's computation, petitioner will be entitled to a deduction for a reserve allowance based upon one of the other formulae provided in section 593. It is significant to note that petitioner will be entitled to claim the largest deduction permissible under the methods which are not dependent upon gauging the maximum limit upon a percentage of taxable income. This will not place petitioner at a disadvantage in relation to other taxpayers carrying back net operating losses. Indeed, even after calculating the absorption of the loss by the method prescribed in the regulations, petitioner will remain in an advantaged position because it will not lose the ability to offset some amount of the NOLD by means of its statutorily computed addition to its loss reserve. Taxpayers who might lose the ability to claim a contribution deduction because of the interplay of a net operating loss in a particular year are not offered alternative methods of claiming that deduction. Although petitioner may lose the ability to claim the maximum benefit of the more generous percentage of taxable income method of computing its loss allowance, it would remain squarely within the intended congressional framework.

The adjustment to taxable income and resulting reduction to the reserve addition based upon taxable income is practically no different from the mechanical changes that affect "below the line" medical deductions and charitable and other percentage limitations based upon changes to adjusted gross or taxable income. See for example *Lustman v. Commissioner,* T.C. Memo. 1960-116, affd. 322 F.2d 253 (3d Cir. 1963). Likewise, on occasion, a change in basis may generate a concomitant change in depreciation. *Commissioner v. Superior Yarn Mills,* 228 F.2d 736 (4th Cir. 1955).

Supreme Court Precedent

In *United States v. Foster Lumber Co.*, 429 U.S. 32 (1976), the Supreme Court considered a strikingly similar interaction between two relief or benefit provisions of the Internal Revenue Code. In that case, the focus, as it is here, centered upon the definition of "taxable income" for purposes of carrying back and applying a NOLD to a prior year. In *Foster Lumber*, the taxpayer had used an alternative computation of tax liability which was intended to insure that capital gains were not taxed above a certain rate, which rate may be more favorable than the rates on other types of income.

The alternative computation is made separately from the computation of other income, and, for computational purposes only, the amount of taxable income reflected in part of the computation does not include income from capital gains. In *Foster Lumber*, the alternative computation produced a lower tax than the regular computation. But the interplay of the NOLD from a subsequent year caused the absorption of all taxable income without permitting the benefit of the capital gains tax rate. The question decided by the Supreme Court was whether capital gain income had to be used as part of taxable income to be absorbed by the NOLD before it was carried to other taxable years.[5] The taxpayer argued that it would lose the benefit of the alternative tax computation if the capital gain portion of taxable income was used to absorb a portion of the NOLD. The Government argued that capital gain income was part of taxable income and must be used in the absorption process. The Supreme Court held for the Government.

In so holding, the Supreme Court, in part, rested its decision upon the concept that taxable income includes capital gains and the NOLD must be applied against or absorbed by all taxable income, irrespective of its characterization as ordinary or capital. The Court was cognizant that the use of the alternative tax computation produced a lower tax liability and that capital gains were not, in the

[5] This is, in essence, the same question which we address in this case. The only difference is one case involved an addition to taxable income (capital gains) and the other involves a reduction from taxable income (reserve allowance deduction). Otherwise, in principle and practice, the matters should be treated homogeneously.

computational sense, a part of taxable income when using the alternative capital gains method of computing the tax liability. Accordingly, the Supreme Court in *Foster Lumber* was forced, as we are in this case, to consider two competing benefits conferred by Congress. Its holding resulted in the taxpayer not receiving the full benefit of the alternative capital gains computation.[6]

In this case we are also confronted with a situation where there is interplay between two benefit provisions. As in *Foster Lumber,* carryback loss deductions are involved. Here, however, we consider a provision permitting certain savings institutions to liberally compute their loss reserves. Like the beneficial capital gains rates in *Foster Lumber,* petitioner had the benefit of a liberal section 593 artificial computation of the addition to its loss reserve based upon a percentage of taxable income. Similarly, the introduction of the net operating loss deduction reduces taxable income, which under the statutes and regulations would reduce the amount of the addition to the loss reserve if computed by the percentage of taxable income method. And finally, and again similar to *Foster Lumber,* the question concerns the concept or definition of "taxable income." Unlike *Foster Lumber,* the petitioner here will receive a congressionally intended deduction which will have the effect of increasing the amount of the NOLD carried to subsequent years. The difference is that the amount carried forward will be somewhat less than the amount petitioner seeks.

As in *Foster Lumber,* the majority here should have protected the concept of "taxable income" and the internal harmony of the tax code. As in *Foster Lumber,* the majority should have strived to treat all taxpayers utilizing net operating losses equally, unless there is a contrary and express congressional mandate to treat them otherwise. To have done so would not cause petitioner any overall hardship. If the majority had not invalidated the regulation, petitioner would have been treated, at very least, equal to other taxpayers who incurred net operating loss deductions. Instead, the majority's invalidation of the section 593

[6]See Justice Blackmun's dissent for further explanation of the benefits involved and the failure of the taxpayer to receive part of the benefits congressionally intended. *United States v. Foster Lumber Co.,* 429 U.S. 32, 49-52 (1976).

regulations here will permit petitioner a refund which is larger than the amount to which it is entitled. Moreover, the excess refund will not, in all circumstances, be recouped in some future taxable year. This is not simply a matter of timing.

I respectfully submit that petitioner should not be permitted to utilize an addition to its loss reserve based upon a concept of taxable income not specifically mandated in the statutes and/or unavailable to all taxpayers equally.

PARKER, JACOBS, PARR, and RUWE, *JJ.*, agree with this dissent.

STATUTES AND REGULATION INVOLVED

Section 593 of the Internal Revenue Code of 1954, as amended and in force for the years at issue states in relevant part:

(b) ADDITION TO RESERVES FOR BAD DEBTS. –

(1) IN GENERAL. – For purposes of section 166(c), the reasonable addition for the taxable year to the reserve for bad debts of any taxpayer described in subsection (a) shall be an amount equal to the sum of –

(A) the amount determined to be a reasonable addition to the reserve for losses on nonqualifying loans, computed in the same manner as is provided with respect to additions to the reserves for losses on loans of banks under section 585(b)(3), plus

(B) the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans, but such amount shall not exceed the amount determined under paragraph (2), (3), or (4), whichever amount is the largest . . .

(2) PERCENTAGE OF TAXABLE INCOME METHOD.

(A) IN GENERAL. – Subject to subparagraph (B), (C), and (D), the amount determined under this paragraph for the taxable year shall be an amount equal to the applicable percentage of the taxable income for such year (determined under the following table):

For a taxable year beginning in	The applicable percentage under this paragraph shall be
1969	60 percent
1970	57 percent
1971	54 percent
1972	51 percent
1973	49 percent
1974	47 percent
1975	45 percent
1976	43 percent
1977	42 percent
1978	41 percent
1979 or thereafter	40 percent

[. . .]

(E) COMPUTATION OF TAXABLE INCOME. – For purposes of this paragraph, taxable income shall be computed –

(i) by excluding from gross income any amount included therein by reason of subsection (e),

(ii) without regard to any deduction allowable for any addition to the reserve for bad debts,

(iii) by excluding from gross income an amount equal to the net gain for the taxable year arising from the sale or exchange of stock of a corporation or of obligations the interest on which is excludable from gross income under section 103,

(iv) by excluding from gross income an amount equal to the lesser of 18/46 of the net long-term capital gain for the taxable year or 18/46 of the net long-term capital gain for the taxable year from the sale or exchange of property other than property described in clause (iii), and

(v) by excluding from gross income dividends with respect to which a deduction is allowable by part VIII of subchapter B, reduced by an amount equal to the applicable percentage (determined under subparagraphs (A) and (B)) of the dividends received deduction (determined without regard to section 596) for the taxable year.

26 U.S.C. § 593(b) (1970).

The Treasury Regulations published in 1956 provided in pertinent part:

(b) Addition to reserve. Except as otherwise provided in §1.593-2, the reasonable addition to a reserve for bad debts shall be any amount determined by the taxpayer which does not exceed the lesser of:

(1) The amount of its taxable income for the taxable year, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts),

Treas. Reg. §1.593-1(b)(1) (1956), T.D. 6188, reproduced in 1956-2 C.B. 310, 321.

The Treasury Regulations published in 1964 provided in pertinent part:

> (2) Taxable income defined. - For purposes of this paragraph, taxable income shall be computed --
>
> (i) By excluding from gross income any amount included therein by reason of the application of §1.593-10 (relating to certain distributions to shareholders by a domestic building, and loan association);
>
> (ii) Without regard to any deduction allowable under section 166(c) for an addition to a reserve for bad debts;
>
> (iii) Without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), other than sections 243, 244 and 245 (relating to deductions for dividends received); and
>
> (iv) Without regard to any net operating loss carryback to such year under section 172.

In computing the deductions under sections 243, 244, and 245, section 246(b) (relating to limitation on aggregate amount of deduction) shall not apply. For purposes of subdivision (iii) of this subparagraph, a net operating loss deduction under section 172 is not a deduction the amount of which is dependent upon the amount of taxable income.

Treas. Reg. §1.593-6(b) (1964), T.D. 6728, reproduced in 1964-1 C.B. 195, 202.

The Treasury Regulation published in 1978, as amended in 1979, states in pertinent part:

(5) COMPUTATION OF TAXABLE INCOME. For purposes of this paragraph, taxable income is computed –

(vi) For taxable years beginning before January 1, 1978, without regard to any deduction the amount of which is computed upon, or may be subject to a limitation computed upon, the amount of taxable income, and without regard to any net operating loss carryback to such year from a taxable year beginning before January 1, 1979. (For purposes of this subparagraph, a net operating loss deduction under section 172 is not

a deduction the amount of which may be subject to a limitation computed upon the amount of taxable income.)

(vii) For taxable years beginning after December 31, 1977, by taking into account any deduction the amount of which is computed upon or may be subject to a limitation computed upon the amount of taxable income, and any other deduction or loss allowed under subtitle A of the Code, such as any deduction allowable under section 172 or any loss allowable under section 1212(a), unless otherwise provided in this subparagraph.

Treas. Reg. § 1.593-6A(b)(5) (1979), T.D. 7549, reproduced in 1978-1 C.B. 185, 189-190, *as amended by* T.D. 7626, reproduced in 1972-2 C.B. 239, 240.[1]

[1]The 1979 amendments merely changed the effective dates.

GEORGIA FEDERAL BANK, F.S.B. AND SUBSIDIARIES, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 26870-90. Filed February 4, 1992.

From 1970 through 1982, P deducted additions to its bad debt reserve. The amounts deducted were calculated with reference to P's taxable income for each year. From 1980 through 1984, P sustained net operating losses (NOL's). *Held*, subdivisions

(vi) and (vii) of sec. 1.593-6A(b)(5), Income Tax Regs. are invalid to the extent they require that taxable income reflect any NOL carrybacks before the addition to bad debt reserve is calculated for certain financial institutions. *Pacific First Federal Savings Bank v. Commissioner*, 94 T.C. 101 (1990), on appeal (9th Cir., Feb. 8, 1991), followed. *Peoples Federal Savings & Loan Association of Sidney v. Commissioner*, 948 F.2d 289 (6th Cir. 1991), revg. T.C. Memo. 1990-129, not followed.

Robert M. Fink and *Roger S. Reigner, Jr.*, for petitioner.
Bonnie L. Cameron, for respondent.

OPINION

WELLS, *Judge:* The instant case is before us on petitioner's motion for summary judgment. Respondent determined a deficiency of $114,193 in petitioner's Federal income tax for its taxable year ended April 11, 1986. At the time the petition in the instant case was filed, petitioner's principal place of business was located in Atlanta, Georgia. From 1970 through 1982, petitioner computed its deduction for the addition to its bad debt reserves using the percentage of taxable income method set forth in section 593(b)(2)(A).[1] From 1980 through 1984, petitioner sustained net operating losses (NOL's) within the meaning of section 172(c), which NOL's may be carried back under section 172(b)(1)(F) to each of the 10 taxable years preceding the loss years.

The parties agree that the sole issue presented is the validity of subdivisions (vi) and (vii) of section 1.593-6A(b)(5), Income Tax Regs., under which respondent seeks to calculate petitioner's tax liability for its taxable year ending April 11, 1986. The challenged provisions generally provide that taxable income is to be reduced by any NOL carrybacks before the deduction for addition to bad debt reserve is calculated. Sec. 1.593-6A(b)(5)(vii), Income Tax Regs. Such regulations were adopted May 17, 1978 (the 1978 regulations). T.D. 7549, 1978-1 C.B. 185. Taking NOL carrybacks into account in such manner reduces the base of taxable income on which the bad debt reserve addition is calculated, and so reduces the deduc-

[1] Unless otherwise noted, all section references are to the Internal Revenue Code in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

tion below the amount originally calculated in the taxable year to which the NOL carryback is applied.

The 1978 regulations changed the method by which a mutual institution's bad debt reserve addition is calculated in a year to which an NOL carryback is applied. The first regulations interpreting section 593 provided that taxable income is to be computed "without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income". Sec. 1.593-1(b)(1), Income Tax Regs., T.D. 6188, 1956-2 C.B. 310, 321 (the 1956 regulations). The 1956 regulations were cited in Rev. Rul. 58-10, 1958-1 C.B. 246, which provided that, for purposes of calculating the bad debt reserve addition, taxable income was not to be reduced by NOL carrybacks. The 1958 revenue ruling was incorporated in changes to the regulations adopted in 1964. Sec. 1.593-6(b)(2)(iv), Income Tax Regs., T.D. 6728, 1964-1 C.B. 195, 202 (the 1964 regulations). Thus, the 1978 regulations challenged by petitioner reversed an ordering rule that had been in effect for approximately 20 years.

The issue of which of the two opposing interpretations should be sustained was decided by this Court in *Pacific First Federal Savings v. Commissioner,* 94 T.C. 101 (1990), on appeal (9th Cir., Feb. 8, 1991). We held, based on our review of the structure of section 593(b) and its legislative history, that the 1978 regulations were invalid because they did not harmonize with Congressional intent. Recently, the Sixth Circuit disagreed with our conclusion and upheld the 1978 regulations. *Peoples Federal Savings & Loan Association of Sidney v. Commissioner,* 948 F.2d 289 (6th Cir. 1991), revg. T.C. Memo. 1990-129. In our Memorandum Opinion in *Peoples Federal,* we granted summary judgment on the basis of our opinion in *Pacific First Federal.* The Sixth Circuit reversed. After due consideration and with due respect to the Sixth Circuit, we conclude that our holding in *Pacific First Federal* was correct, and we therefore will follow it in cases not appealable to the Sixth Circuit. See *Golsen v. Commissioner,* 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

In *Peoples Federal,* the Sixth Circuit held that we failed to give proper deference to the 1978 regulations under the principles set forth in *Chevron, U.S.A. v. Natural Res. Def. Council,* 467 U.S. 837 (1984). We therefore will begin our

analysis in the instant case by discussing those principles. In *Chevron*, the Supreme Court reviewed the standards courts must employ in deciding the reasonableness of an agency's interpretation of statutory law. First the court must decide whether Congress had an intention on the question in issue. *Chevron, U.S.A. v. Natural Res. Def. Council*, 467 U.S. at 842-843. Such a question is a matter of statutory construction, on which the judiciary is the final authority. *Chevron, U.S.A. v. Natural Res. Def. Council*, 467 U.S. at 843 n.9.

If a court, using the traditional tools of statutory construction, such as the plain language, structure, and legislative history of the law, ascertains that Congress has addressed the precise question at issue, that is the end of the matter. *Chevron, U.S.A. v. Natural Res. Def. Council*, 467 U.S. at 842-843. Thus, "If Congress has spoken to the issue with which we are concerned, there is no need for deference" to an agency's construction of the law. *U.S. Mosaic Tile Co. v. N.L.R.B*, 935 F.2d 1249, 1255 (11th Cir. 1991).

If, on the other hand, the court concludes that the statute is silent or ambiguous with respect to the specific issue, the question for the court is "whether the agency's answer is based on a permissible construction of the statute." *Chevron, U.S.A. v. Natural Res. Def. Council*, 467 U.S. at 843. The principle of deference embodied in such standard of review, however, "only sets 'the framework for judicial analysis; it does not displace it.'" *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982) (quoting *United States v. Cartwright*, 411 U.S. 546, 550 (1973)). "[T]he essential function of judicial review, in this context, is to ensure that the agency engaged in 'reasoned decisionmaking'." *United States v. Garner*, 767 F.2d 104, 116 (5th Cir. 1985). The courts—

> [have] firmly rejected the suggestion that a regulation is to be sustained simply because it is not "technically inconsistent" with the statutory language, when that regulation is fundamentally at odds with the manifest congressional design. [*United States v. Vogel Fertilizer*, 455 U.S. at 26.]

A reviewing court should consider the agency's reaction to objections raised by the public and how the agency rebutted vital relevant comments during the regulatory process. *Lloyd Noland Hospital & Clinic v. Heckler*, 762 F.2d 1561, 1566-1567 (11th Cir. 1985), citing *Western Coal Traffic League v. United States*, 677 F.2d 915, 927 (D.C. Cir. 1982). To guard against

arbitrary action, a court must engage in a "'thorough, probing, in-depth review' of the agency's asserted basis for [its] decision, ensuring that 'the agency [has] * * * examine[d] the relevant data and [has] articulate[d] a satisfactory explanation for its action'". *Midtec Paper Corp. v. United States,* 857 F.2d 1487, 1498 (D.C. Cir. 1988) (quoting *Motor Vehicle Manufacturers Association v. State Farm Mutual Ins. Co.,* 463 U.S. 29, 43 (1983), and *Citizens to Preserve Overton Park v. Volpe,* 401 U.S. 402, 415 (1971)).

Many factors have been applied to aid in the decision as to whether the agency's interpretation is a reasonable construction of the statute. A regulation which is a substantially contemporaneous construction of the statute is entitled to special weight, as its drafters are presumed to have a greater awareness of congressional intent, and such construction is therefore more likely to reflect such intent. *Rowan Cos. v. United States,* 452 U.S. 247, 253 (1981); *National Muffler Dealers Association v. United States,* 440 U.S. 472, 477 (1979). Where a contemporaneous construction remains consistent over a long period of time, it is entitled to special deference. *EEOC v. Associated Dry Goods Corp.* 449 U.S. 590, 600 n.17 (1981).

If a regulation dates from a period after the enactment of the statute which it interprets, or repudiates an earlier interpretation, the manner in which it evolved merits inquiry. *National Muffler Dealers Association v. United States,* 440 U.S. at 477; *State of Washington v. Commissioner,* 77 T.C. 656, 671 n.12 (1981), affd. 692 F.2d 128 (D.C. Cir. 1982). Additional considerations include the length of time it has been in effect, the consistency of the agency's interpretation, and the degree of scrutiny which Congress has devoted to the regulation during subsequent reenactments of the statute. *NLRB v. Food & Commercial Workers Local 23,* 484 U.S. 112, 124 n.20 (1987); *National Muffler Dealers Association v. United States,* 440 U.S. 472, 477 (1979).

An agency has the flexibility to modify its regulations in the light of experience and to respond to changed circumstances. *Chevron, U.S.A. v. Natural Res. Def. Council,* 467 U.S. at 863-864. If an agency reverses a prior statutory interpretation, however, its most recent expression may be accorded less deference than a consistently maintained position. *INS v.*

Cardoza-Fonseca, 480 U.S. 421, 446 n.30 (1987); *Watt v. Alaska,* 451 U.S. 259, 273 (1981); *Seldovia Native Association, Inc. v. Lujan,* 904 F.2d 1335, 1345 (9th Cir. 1990). "Sharp changes of agency course constitute 'danger signals' to which a reviewing court must be alert." *West v. Bowen,* 879 F.2d 1122, 1127 (3d Cir. 1989) (quoting *Natural Resources Defense Council v. U.S.E.P.A.,* 683 F.2d 752, 760 (3d Cir. 1982)).

An agency which changes its position must acknowledge that its interpretation has shifted, and must supply a persuasively reasoned explanation for the change. *Motor Vehicle Manufacturers Association v. State Farm Mutual Ins. Co.,* 463 U.S. at 48; *Vargas v. I.N.S.,* 938 F.2d 358, 360 (2d Cir. 1991) (agency changing course must supply "sound reasons for the change"); *GMC v. National Highway Traffic Safety Admin.,* 898 F.2d 165, 175 (D.C. Cir. 1990); *Acadian Gas Pipeline System v. F.E.R.C.,* 878 F.2d 865, 870 (5th Cir. 1989); *Lloyd Noland Hospital & Clinic v. Heckler,* 762 F.2d 1561, 1567 (11th Cir. 1985). "[T]he thoroughness, validity, and consistency of an agency's reasoning are factors that bear upon the amount of deference to be given an agency's [interpretation]". *FEC v. Democratic Senatorial Campaign Comm.,* 454 U.S. 27, 37 (1981).

Furthermore, "an agency's action must be upheld, if at all, on the basis articulated by the agency * * * [at the time of the rule making]." *Motor Vehicle Manufacturers Association v. State Farm Mutual Ins. Co.,* 463 U.S. at 50; *Chemical Manufacturers Association v. E.P.A.,* 899 F.2d 344, 359 (5th Cir. 1990). "The reviewing court should not attempt itself to make up for such deficiencies; we may not supply a reasoned basis for the agency's action that the agency itself has not given." *Motor Vehicle Manufacturers Association v. State Farm Mutual Ins. Co.,* 463 U.S. at 43. Thus, post hoc rationalizations cannot be offered to buttress an agency's action, as they are unreliable indicators of the actual basis for an agency's course of action.

Turning to the instant case, as the foregoing authorities demonstrate, *Chevron's* rule of deference only applies if Treasury's new interpretation is not contrary to the clear intent of Congress. *Chevron, U.S.A. v. Natural Res. Def. Council,* 467 U.S. at 843-845. In *Pacific First Federal,* our review of the legislative history disclosed that Congress intended that mutual institutions' reserves be curtailed only to a point, and not beyond. The Sixth Circuit did not disagree

with that interpretation. Rather, it characterized our analysis as a variant of the reenactment doctrine and stated that our reliance on that doctrine was misplaced, even though we specifically stated, as noted by the Sixth Circuit, that we did not rely on the reenactment doctrine.

In *Pacific First Federal,* after analyzing the legislative history, we concluded that the legislative history revealed that Congress reached a compromise on the effective tax rate for mutual institutions. We also concluded that the new ordering rule contained in the 1978 regulations increased the effective tax rate beyond the level Congress intended by contracting the taxable income base to which the applicable percentage is applied in computing the deduction under section 593(a)(2). Moreover, we concluded that the new ordering rule reduced the value of NOL carrybacks contrary to Congress' *expressed* intent of granting a "more generous net operating loss carryback" and that *any* modification of the taxable income base would upset the legislative compromise in 1969. *Pacific First Federal Savings Bank v. Commissioner,* 94 T.C. at 110-114.

We remain convinced that the 1978 regulations contravene Congress' intent. Although *Chevron* was not cited to us in *Pacific First Federal, Peoples Federal,* or the instant case, the application of *Chevron's* rule of deference by the Sixth Circuit in *Peoples Federal* suggests that we should consider it in the context of the instant case.

In *Peoples Federal,* the Sixth Circuit noted several reasons advanced by Treasury when it changed its course in 1978, citing an internal memorandum[2] prepared for senior officials of Treasury in 1978 (the 1978 memorandum). The Sixth Circuit held that the reasons set forth in the 1978 memorandum were "conclusive evidence that the Commissioner's change was a deliberate one," i.e., not arbitrary. *Peoples Federal Savings & Loan Association of Sidney v. Commissioner,* 948 F.2d at 303. According to the 1978 memorandum, in substance, Treasury concluded that the 1964 regulations were "patently wrong" and that adoption of a contrary position was

[2]Attachment to Memorandum to Secretary Blumenthal from Acting Asst. Secretary (Tax Policy) Lubick, Joint Exh. 130-DZ in *Pacific First Federal Savings Bank v. Commissioner,* 94 T.C. 101 (1990). Although the 1978 memorandum was a part of the record in *Pacific First Federal,* we did not find the statements in the memorandum to be persuasive. We did not feel the need to consider the reasons for the change once we found that the 1978 regulations contravened Congress' intent.

in order. We respectfully disagree, however, with the Sixth Circuit's holding that the reasons offered in the 1978 memorandum are conclusive of Treasury's lack of arbitrariness.

Before turning to our disagreement with the specific reasons set forth in the 1978 memorandum, the stage should be set with a discussion of the reason Treasury initially advanced for the change made by the 1978 regulations. Treasury's original[3] view was that, by amending section 593(b)(2)(E)[4] in 1969, Congress intended to create an exclusive list of modifications to the taxable income of savings banks for purposes of the bad debt deduction. An examination of the manner in which such provision came to form part of the Code, however, shows that Congress could not have had the intent ascribed to it by Treasury and that the Congressional action cannot possibly bear the weight of inference which Treasury placed upon it. The 1969 amendments to section 593(b)(2)(E) consisted of technical amendments proposed by Treasury to remove from the taxable income base, upon which the bad debt reserve addition was calculated, certain types of income which did not give rise to bad debt losses. H. Rept. 91-413, 1969-3 C.B. 200, 279. The proposed technical amendments were accepted with little discussion by Congress, and the legislative history contains no reference to the rule governing NOL carrybacks. As the 1978 memorandum states "there is no evidence Congress considered the matter". Moreover, the technical amendments generated little controversy when they were proposed, while the history of the 1951, 1962, and 1969 legislation shows that every other effort to significantly reduce the percentage method of calculating the bad debt reserve addition had been attended by substantial controversy, indicating that, at the time of the 1969 Act, no one considered that the technical amendments would have the effect of reversing the established rule regarding NOL carrybacks. Indeed, the 1978 memorandum admits as much, stating that "if the industry had known that we [Treasury] would consider changing the regulations, it would probably have raised the issue with Congress."

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[3] Treasury's original justification for the change was set forth in a Technical Memorandum attached to Transmittal Memorandum from Acting Commissioner Swartz to Assistant Secretary Cohen, July 7, 1971, Exh. 24-X in *Pacific First Federal*.

[4] The Tax Reform Act of 1986 redesignated such subparagraph as sec. 593(b)(2)(D). Pub. L. 99-514, sec. 901(b)(2)(B), 100 Stat. 2085, 2378.

In summary, the 1969 amendments to section 593(b)(2)(E) represented a limited modification to the definition of taxable income and did not represent the result of a comprehensive Congressional study of the taxable income base, which would be necessary if we were to accept Treasury's reasoning. The 1969 amendments constituted nothing more than a narrowly focused and technical modification to the percentage method which was not expected to have anything more than a minor impact on the size of the bad debt deduction. Staff of Joint Committee on Internal Revenue Taxation, Summary of Testimony on Mutual Savings Institutions, 91st Cong., 2d Sess. 1-2 (J. Comm. Print 1969). The negative inference which Treasury drew from the 1969 amendments was clearly an insufficient basis for Treasury's change in course. Moreover, we note that, in 1962, Congress had added a limitation to the definition of taxable income in section 593(b)(2)(E) similar to the 1969 changes, but Treasury did not infer from that action that the list of modifications in section 593 was exclusive or that Congress disapproved of the 1956 regulations or Rev. Rul. 58-10. Rather, in the 1964 regulations, Treasury explicitly adopted the ordering rule originally permitted under such authorities. Accordingly, we would have difficulty in accepting Treasury's view that a similar action by a subsequent Congress prevents the continued application of such rule.

We considered such "exclusive list" justification in *Pacific First Federal Savings v. Commissioner,* 94 T.C. at 113-114, but did not find it persuasive. Moreover, we noted that the Commissioner appeared to abandon such argument, indicating a lack of confidence in its merit. *Id.* at 114. Furthermore, the Sixth Circuit did not expressly refute our refusal to accept such justification for the change contained in the 1978 regulations, and we therefore do not accord any weight to such justification.

Turning to a consideration of the justifications mentioned in the 1978 memorandum, the first justification noted by the Sixth Circuit was the statement that the change was being made in order to compute taxable income for purposes of section 593(b) as it "ordinarily" is under the Code. Although such statement implies that Treasury was attempting to achieve consistency in the definition of taxable income, in the

1956 and 1964 regulations, Treasury did not find it essential that the definition of taxable income for purposes of section 593(b) be the same as elsewhere in the Code. Moreover, Treasury did not explain how such consistency would better effectuate the Congressional purpose underlying section 593(b). Furthermore, respondent does not uniformly adhere to the definition of taxable income inherent in the 1978 regulations, but in some cases instead has adopted an ordering rule contrary to that adopted in the 1978 regulations. For instance, in Rev. Rul. 60-164, 1960-1 C.B. 254, the Commissioner ruled that in computing percentage depletion under section 613(a), an NOL is not to be taken into account in determining a taxpayer's taxable income from the property.

We also note that, by requiring the elimination or reduction of bad debt reserve additions which were reasonable in the year they were originally calculated, the 1978 regulations contravene the well-established principle that additions to bad debt reserves are not to be altered on account of events occurring after the year the reserve is calculated. *Westchester Development Co. v. Commissioner,* 63 T.C. 198, 212 (1974); *Rio Grande Building & Loan Association v. Commissioner,* 36 T.C. 657, 664 (1961); *C.P. Ford & Co. v. Commissioner,* 28 B.T.A. 156, 159 (1933); sec. 1.166-4(b), Income Tax Regs.

Courts have recognized that section 593 simply provides a method for calculating an addition to bad debt reserves, a deduction for which was provided by section 166(c). *Arcadia Savings & Loan Association v. Commissioner,* 300 F.2d 247, 251 (9th Cir. 1962), affg. 34 T.C. 679 (1960) (section 593 furnishes a formula for the reserve addition but does not change the nature of the deduction); *Rio Grande Building & Loan Association v. Commissioner,* 36 T.C. at 662. The position taken in the 1956 and 1964 regulations, as well as in Rev. Ruls. 58-10, 1958-1 C.B. 246, and 74-188, 1974-1 C.B. 147, was consistent with the well-settled principles governing additions to bad debt reserves. The 1978 regulations, therefore, are contrary to judicial precedents and respondent's own rulings and their adoption created a greater inconsistency than they resolved.

The next justification noted by the Sixth Circuit was the statement in the 1978 memorandum that "the percentage of

taxable income method is in substance a technique to lower the tax rate on thrift institutions." We are constrained to point out, however, that Congress has expressly permitted mutual institutions to use such method in figuring their deductions. Sec. 593(b)(2). Treasury cannot contravene Congress' will by imposing excessive restrictions on the method or impeding the ability of mutual institutions to make use of it simply because Treasury perceives it to be a tax reduction "technique." If respondent believes that the method is improper, he should apply to Congress for a change in the law, rather than seek to change tax policy by means of administrative fiat.

The legislative history of section 593 reveals that Treasury had repeatedly sought to persuade Congress to deny mutual institutions the right to use the percentage of income method. In 1951, when Congress first subjected mutual institutions to the Federal income tax, Treasury proposed that the deduction for bad debt reserve addition be calculated in the manner prescribed for commercial banks.[5] Congress, however, decided to permit a deduction based on the taxable income of the mutual institution so as to permit maintenance of reserves sufficient to absorb losses experienced during downturns in the economy. 97 Cong. Rec. 11842 (1951) (statement of Sen. Lehman), 11843 (statement of Sen. Dirksen), 11888 (statement of Sen. Butler), 11890 (statement of Sen. Capehart).

In connection with Congressional consideration of the 1962 tax legislation, Treasury proposed abolition of the percentage method, arguing that it improperly allowed mutual institutions to build up reserves tax-free. Taxation of Mutual Savings Banks and Savings and Loan Associations: Hearings on Treasury Department Report on Taxation of Mutual Savings Bank and Savings and Loan Associations Before the House Committee on Ways and Means, 87th Cong., 1st Sess. 11-14 (1961). Congress, however, declined to adopt Treasury's recommendation, although it did cap the deduction at 60 percent of a mutual institution's taxable income. H. Rept. 1447, 87th Cong., 2d Sess., 1962-3 C.B. 405, 437-438.

[5] Staffs of the Treasury and Joint Committee on Internal Revenue Taxation, Mutual Savings Banks and Building & Loan Associations 4 (1951).

Similarly, during the legislative process leading up to the Tax Reform Act of 1969, Treasury again criticized the percentage method and urged its replacement with the bad debt reserve deduction based on actual experience. Tax Reform Studies and Proposals, U.S. Treasury Department, 91st Cong., 1st Sess. 458-475 (J. Comm. Print 1968); Technical Memorandum of Treasury Position, Tax Reform Act of 1969, H. Rept. 13270, 80-84 (J. Comm. Print 1969). Congress again declined to abolish the method, although it did provide for a phased reduction in the maximum amount of the deduction to 40 percent of taxable income, while increasing the loss carryback and carryforward periods to protect institutions in the event of unusually heavy losses. H. Rept. 91-782, 1969-3 C.B. 644, 664; H. Rept. 91-413, 1969-3 C.B. 200, 280.

The 1978 regulations, however, contravene the clearly expressed intent of Congress by denying mutual institutions the benefit of section 593 to the extent they experience net operating losses. The 1978 regulations in effect recapture percentage method deductions to the extent to which NOL carrybacks are applicable. In the case of mutual institutions experiencing losses, the 1978 regulations therefore achieve what Congress repeatedly has denied Treasury: a form of repeal of the percentage method. The 1978 regulations thwart Congress' efforts to assure that mutual institutions would maintain adequate reserves to protect depositors by transforming reserve additions into little more than loans from the treasury, to be called in when a mutual institution begins to suffer the consequences of a downturn in the economy.

Another justification mentioned by the Sixth Circuit was the statement in the 1978 memorandum that the method of calculating the bad debt reserve addition prescribed by the 1964 regulations resulted in an inappropriate and unintentional "pyramiding" of tax benefits. Evidently, Treasury found it objectionable that a mutual institution could reduce its taxable income by NOL carrybacks and still claim a reserve addition based on the amount of net income originally reported for a taxable year. Such a result was not found improper in Rev. Rul. 58-10, 1958-1 C.B. 246, in which the Commissioner ruled that the bad debt reserve addition should not be affected by events occurring after the year in which such addition was calculated. It appears that such a result would be problematic

only if the view is taken that a mutual institution applying an NOL carryback should be treated as if the NOL had actually been incurred in the carryback year, which is the position that Treasury apparently adopted in formulating the 1978 regulations. See G.C.M. 39701 (Feb. 25, 1988). We, however, fail to see why such a view is preferable to or more correct than the reasoning expressed in the 1958 ruling underpinning the 1964 regulation. Indeed, there is no "pyramiding" if the 1964 regulations are analyzed under the principles applicable to bad debt reserves, with which such regulations are in accord. As discussed above, the reasonableness of an addition to bad debt reserves is decided as of the year it is made, and subsequent events do not affect such decision. Consequently, a mutual institution that makes a reasonable addition to its reserves in one year does not receive an inappropriate or excessive benefit simply because later occurring events give rise to an NOL carryback to such year. Furthermore, as we pointed out in *Pacific First Federal,* section 593 does not allow a double deduction on account of bad debt losses, as actual losses are charged against the reserve and no deduction is obtainable for such losses. *Pacific First Federal Savings v. Commissioner,* 94 T.C. 101, 116 (1990). NOL's incurred by mutual institutions thus have no relationship to the bad debt reserve.

We also note a statement made in the 1978 memorandum which was not discussed by the Sixth Circuit but which discloses the apparent arbitrariness of Treasury's action. The 1978 memorandum states that the rule was not changed in the early 1970s, when initially considered by Treasury, because of poor economic conditions. If the change were being made because the rule was "patently wrong", as suggested by Treasury, we fail to see why Treasury did not go forward with its responsibility in carrying out its perception of Congress' intent. The fact that Treasury waited 7 years to effectuate the change in assumedly better economic times indicates that Treasury was usurping Congress' role in deciding how much and when to raise the effective tax on mutual institutions.

The Sixth Circuit identified an additional justification that was not mentioned in the 1978 memorandum. The Sixth Circuit reasoned that the "trend" in the congressional enactments toward a curtailment of the bad debt reserve deduction was evidence that Congress intended to reduce the deduction

available for addition to bad debt reserves and therefore Treasury's interpretation was consistent with such intent. *Peoples Federal Savings & Loan Association of Sidney v. Commissioner,* 948 F.2d 289 (6th Cir. 1991). Such a justification appears to be a "post hoc rationalization" of the change that should not be considered. *Motor Vehicle Manufacturers Association v. State Farm Mutual Auto Ins. Co.,* 463 U.S. 29, 43, 50 (1983). Moreover, we note that the 1962 and 1969 reductions in the amount of the deduction were reached only after review of the tax situation of the industry and considerable negotiation between the two chambers of Congress. Congress undertook to reduce the size of the deduction in a measured, deliberate compromise. Congress, however, did not signal that the deduction was to be further reduced below the level it prescribed by legislation.

Finally, we are not convinced that Treasury adequately rebutted the "vital relevant comments" received by it from the industry during the period the changes were being considered. *Lloyd Noland Hosp. & Clinic v. Heckler,* 762 F.2d 1561, 1567-1568 (11th Cir. 1985).

For the foregoing reasons, we hold that Treasury failed to offer a cogent, persuasive explanation for the change as required by *Chevron.* Given the circumstances surrounding the 1969 changes to section 593, the 1978 regulations were not a reasonable interpretation of the statute and were inconsistent with what Congress intended. We must apply the Internal Revenue Code as Congress has written it, not as respondent would like it amended. Consequently, we adhere to our prior holding of *Pacific First Federal* that the 1978 regulations are invalid, and petitioner's motion for summary judgment will be granted.

To reflect the foregoing,

An appropriate order will be issued, and decision will be entered for petitioner.

Reviewed by the Court.

NIMS, CHABOT, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, COLVIN, HALPERN, and BEGHE, *JJ.*, agree with the majority opinion.

WHALEN, *J.*, concurs in the result only.

HALPERN, *J.*, concurring. I write separately to emphasize the distinction between the reenactment doctrine and the reasoning of the majority.

As stated by the Court of Appeals for the Sixth Circuit in *People's Federal Savings & Loan Association of Sidney v. Commissioner*, 948 F.2d 289 (6th Cir. 1991), revg. T.C. Memo. 1990-129, a recent expression of the reenactment doctrine is found in *NLRB v. Bell Aerospace Co.*, 416 U.S. 267 (1974). In that case, where the National Labor Relations Board had consistently interpreted the Taft-Hartley Act of 1947 as excluding "managerial employees", the Supreme Court concluded that Congress' failure, when it amended the Act in 1959, "to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress". *Id.* at 275. Thus, the reenactment doctrine would appear to rest upon two assumptions: (1) That whenever Congress reenacts a statute, it is aware of the body of interpretation regarding that statute, and (2) that, in such circumstances, Congress' failure to countermand some aspect of that body of interpretation constitutes an affirmative sanction thereof. Together, those assumptions are capable of producing an inference that Congress has sanctioned a given regulation respecting an issue to which Congress has given little or no thought.

Apparently, it is that potential overbreadth that concerned the Sixth Circuit in *Peoples Federal Saving & Loan Association of Sidney v. Commissioner.*

> The re-enactment doctrine is merely an interpretive tool fashioned by the courts for their own use in construing ambiguous legislation. It is most useful in situations where there is some indication that Congress noted or considered the regulations in effect at the time of its action. Otherwise the doctrine may be as doubtful as the silence of the statutes and legislative history to which it is applied. [*Id.* at 302-303. Fn. ref. omitted].

Unfortunately, the Sixth Circuit failed to understand that implicit in the compromise achieved by Congress in 1969 is some understanding regarding taxable income. As we noted in *Pacific First Federal Savings v. Commissioner, supra* at 111:

The House Report also contains a number of statistics, including the following:

Tax as a percent of economic income	*1966*
A. Commercial banks	23.2
B. Mutual savings banks	6.1
C. Savings and loan associations	16.9

In response to the foregoing statistics, the House Report comments:

> Since your committee's bill increases appreciably the 23.2 percent effective rate of tax for commercial banks, it is your committee's intention not only to bring the level of taxation of mutual savings banks (presently 6.1 percent) up to the level of savings and loan associations (16.9 percent), but also to provide an increase in the 16.9 percent rate somewhat comparable to the increase in the 23.2 percent rate for commercial banks. * * *
>
> [H. Rept. 91-413, 1969-3 C.B. at 278.]

Undoubtedly, Congress was aware of the definition of "taxable income" used in computing the percentage-of-taxable-income bad debt deduction when it considered the existing and expected percentage of economic income to be paid as taxes by mutual savings banks. Moreover, there are two readily apparent ways Congress could have chosen to modify that deduction to increase the tax paid by mutual savings banks. The 1969 Congress could have elected (1) to reduce the base against which the percentage was applied to something less than what it was understood to be at that time or (2) to reduce the percentage of taxable income allowed to be deducted. With respect to the goal of achieving the proper aggregate tax to be achieved from mutual savings banks overall, it would have made little difference whether Congress chose the former, the latter, or some combination of the two. Whether the percentage bad debt deduction was to be computed by taking, for example, two-thirds of 50x or one-third of 100x would have been, quite logically, immaterial with respect to the total tax sought to be collected. However, given the relationship between the definition of taxable income and the percentage thereof deductible, Congress' decision to adjust the latter is only meaningful if it presupposes a particular definition of the former. Given that there was no discussion of altering the then established rule of determining taxable income without respect to NOL's, Congress must have assumed that such rule would continue to apply.

Amazingly, however, the Court of Appeals for the Sixth Circuit has concluded that Congress simply did not care whether NOL's are to be deducted in arriving at the figure for taxable income. *People's Federal Savings & Loan Association of Sidney v. Commissioner, supra* at 301 ("there is no evidence in the legislative history of the statutes in question that Congress ever had a specific or particular intent with respect to the ordering rule to be applied in this case"). Pursuing that logic, Congress' struggle to determine the most appropriate extent of the bad debt deduction must seem quite comical. As the Sixth Circuit sees the matter, Congress was indifferent to the total percentage of economic income collected, overall, from the banking institutions in question: all Congress cared about was that the bad debt deduction be limited to a particular percentage of an indeterminate income base.

The facts belie the Sixth Circuit's apparent conclusion that Congress has acted in that irrational a manner. In 1969, it was settled that taxable income was determined without taking NOL's into account. Congress' computations, discussions, and the eventual compromise must necessarily have been based upon that understanding of what taxable income meant.[1] Accordingly, the Commissioner's use of a different definition of taxable income is, in this context, inconsistent with the Tax Reform Act of 1969. I respectfully concur with the majority.

CHABOT, HAMBLEN, and BEGHE, *JJ.*, agree with this concurring opinion.

GERBER, *J.*, dissenting. I respectfully dissent for the reasons already expressed in the dissenting opinion at *Pacific First Federal Savings v. Commissioner,* 94 T.C. 101, 117-126 (1990), and because the majority has not presented persuasive or compelling reasons for disagreeing with the rationale of the

[1]Unfortunately, Congress does not appear to have said so explicitly. No code provision or quotation from the written legislative history can be produced to directly support the point. That does not mean, however, that Congress was indifferent with respect to the ordering rule at question in this case. Where logical reasoning, applied to the sum of the facts and circumstances, can disclose a clear Congressional intent, we are obliged to utilize that tool.

Sixth Circuit Court of Appeals in *Peoples Federal Savings & Loan Association of Sidney v. Commissioner,* 948 F.2d 289 (6th Cir. 1991), revg. T.C. Memo. 1990-129.

The majority's opinion provides us with a large body of Supreme Court articulations concerning the review of regulations which, irrespective of one's particular leaning, would adequately support one's position. The majority's opinion, however, does not provide an adequate rationale or explanation for invalidating the regulations under consideration.[1] That was the shortcoming found by the Court of Appeals in *Peoples Federal Savings & Loan Association of Sidney v. Commissioner, supra.*

The majority's explanation of the Sixth Circuit's opinion is substantially more complex than the Sixth Circuit's opinion. The Circuit Court's opinion addresses the method of review and the role of the judiciary in reviewing regulatory promulgations. The Circuit Court pointed out that, irrespective of whether or not the statute is ambiguous, where an administrative agency's regulatory formulation is a permissible and reasonable interpretation, "a court may not substitute its own construction." *Peoples Federal Savings & Loan Association of Sidney v. Commissioner,* 948 F.2d at 300. The Circuit Court also reviewed the reasons for the Secretary's change of position and admission of an erroneous position (in the earlier regulations) and found the reversal of policy to be reasonable. Some of the Circuit Court's reasoning is also to be found in the *Pacific First Federal Savings v. Commissioner, supra,* dissenting opinion.

In declining to follow the Sixth Circuit's opinion, the majority evaluated and countered each of the Secretary's reasons for reversing the regulation policy. Suffice it to note that the majority's reasons do not negate those of the Circuit Court, but simply reiterate some of the reasoning from *Pacific First Federal Savings v. Commissioner, supra,* and add a few countervailing reasons where prior opinions of this Court did not address the Circuit Court's reasoning. In sum and

[1] In this regard, the majority's opinion here is no less deficient than the majority's opinion in *Pacific First Federal Savings v. Commissioner,* 94 T.C. 101 (1990), or the opinion in *Peoples Federal Savings & Loan Association of Sidney v. Commissioner,* T.C. Memo. 1990-129, revd. 948 F.2d 289 (6th Cir. 1991).

substance, the majority has, a second time, provided some of the same and some alternative reasons for its interpretation, but has not shown the Secretary's interpretation to be an unreasonable or impermissible one.

The rule, correctly articulated by the Circuit Court, is intended to keep courts from substituting their judgment for that of administrative agencies. The majority's holding violates the rule's proscriptive purpose.

PARKER, JACOBS, WRIGHT, PARR, and RUWE, *JJ.*, agree with this dissent.